
LEGISLATIVE FISCAL REPORT

2005 Special Session

Presented to the Fifty-ninth Legislature

Submitted by

The Legislative Fiscal Division

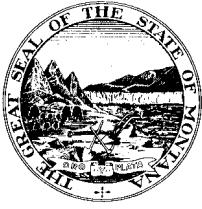
Helena, Montana

January 6, 2006

Legislative Fiscal Division



www.leg.mt.gov/css/fiscal



MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

Room 110 Capitol Building * P.O. Box 201711 * Helena, MT 59620-1711 * (406) 444-2986 * FAX (406) 444-3036

Legislative Fiscal Analyst
CLAYTON SCHENCK

January 6, 2006

Members of the 59th Legislature:

In accordance with 5-12-302, MCA, I submit the Legislative Fiscal Report for the December 2005 special session. This report provides an overview of the circumstances that precipitated a special session, a summary of legislative action enacted in special session, and the revised general fund balance projection for the 2007 biennium.

Further information on the 2007 biennium budget is provided in the Legislative Fiscal Report issued after the 2005 regular session of the legislature.

This report is intended as a reference document and historical archive of legislative budget action for the use of legislators, state agencies, and the public.

Respectfully submitted,

Clayton Schenck
Legislative Fiscal Analyst

TABLE OF CONTENTS

| | |
|--|-----------|
| Table of Contents | iii |
| Legislative Finance Committee..... | v |
| Staff Assignments..... | vii |
| Introduction | 1 |
| Purpose of Report | 1 |
| Background – Why a Special Session?..... | 1 |
| The Governor’s Call..... | 2 |
| Legislative Action in Special Session - Summary..... | 3 |
| Special Session Highlights | 3 |
| Public School Funding..... | 3 |
| Retirement Systems Unfunded Liability | 5 |
| Public Schools Funding Action | 7 |
| Background | 7 |
| Quality Schools Interim Committee..... | 7 |
| Deatailed Summary of Legislative action..... | 8 |
| Ongoing Funding..... | 9 |
| One-Time Funding | 11 |
| Did Legislative Action address Court Requirements?..... | 12 |
| Appropriations for the 2007 Biennium | 13 |
| Retirement Systems Unfunded Liability..... | 15 |
| Introduction..... | 15 |
| Background | 15 |
| Unfunded Liability of PERS, TRS, SRS, and GWPORS | 15 |
| How Much was the Unfunded Liability? | 16 |
| Where did the Unfunded Liability Come From?..... | 16 |
| SAVA Committee Recommendations | 17 |
| Special Session Legislative Action | 18 |
| Revised Unfunded Liability..... | 18 |
| Options for Long-term Resolution of Unfunded Liability | 20 |
| General Fund Summary..... | 23 |
| Introduction..... | 23 |
| 2005 Biennium Ending Fund Balance | 24 |
| 2007 Biennium Projection..... | 26 |
| Revenue Actions | 26 |
| Disbursement Actions | 26 |
| Supplemental Appropriations | 27 |
| Fund Balance Projection | 28 |
| 2009 Biennium Outlook | 29 |
| Revenue Summary..... | 31 |
| General Fund Revenue Estimates | 31 |
| House Joint Resolution 1 | 31 |

| | |
|--|----------------|
| Index To Other LFD Budget Reference Documents | 33 |
| LFD Budget Analysis and Fiscal Report..... | 33 |
| School Funding Primer..... | 33 |
| School Funding Legislation Impact | 33 |
| Training Publications | 33 |
| Fiscal Pocket Guides..... | 34 |
| Appendix A | A-1 |
| Governor's Call | 1 |
| Appendix B | B-1 |
| Revenue Estimates | 1 |
| Revenue Estimate Detail | 3 |
| Corporation Income Tax..... | 4 |
| Individual Income Tax | 7 |
| Oil and Natural Gas Production Tax..... | 11 |
| Property Tax..... | 18 |
| Common School Interest and Income | 21 |
| Appendix C | C-1 |
| HJR 1 Revenue Estimating Resolution | 1 |

Legislative Fiscal Division



www.leg.mt.gov/css/fiscal

LEGISLATIVE FINANCE COMMITTEE

| | |
|------------------------------------|-------------------------------|
| Senator Keith Bales | Representative Gary Branae |
| Senator Rick Laible | Representative Rosalie Buzzas |
| Senator Mike Cooney | Representative John Sinrud |
| Senator Carol Williams | Representative Ray Hawk |
| Senator Don Ryan | Representative Tim Callahan |
| Senator John Cobb, <i>Chairman</i> | Representative Rick Ripley |

LEGISLATIVE FISCAL DIVISION

| | |
|--------------------|----------------------------|
| Clayton Schenck | Legislative Fiscal Analyst |
| Terry Johnson | Principal Fiscal Analyst |
| Taryn Purdy | Principal Fiscal Analyst |
| Jon Moe | Fiscal Specialist |
| Mike Allen | Information Technology |
| Roger Lloyd | Senior Fiscal Analyst |
| Jim Standaert | Senior Fiscal Analyst |
| Lois Steinbeck | Senior Fiscal Analyst |
| Greg DeWitt | Senior Fiscal Analyst |
| Pat Gervais | Senior Fiscal Analyst |
| Cathy Duncan | Senior Fiscal Analyst |
| Marilyn Daumiller | Associate Fiscal Analyst |
| Kris Wilkinson | Associate Fiscal Analyst |
| Barbara Smith | Associate Fiscal Analyst |
| Alan Peura | Associate Fiscal Analyst |
| Shane Siere | Associate Fiscal Analyst |
| Diane McDuffie | Office Manager |
| Cassie Rice-Wetzel | Administrative Support |

LEGISLATIVE FISCAL DIVISION (LFD)

State Capitol, First Floor, East Wing

STAFF ASSIGNMENTS

General Government & Transportation

Greg Dewitt (Ext. 5392, Office #119)

Secretary of State
Transportation
Revenue
Administration
Appellate Defender Commission

Kris Wilkinson (Ext. 5834, Office #108B)

Legislative Branch
Consumer Counsel
Mt. Chiropractic Legal Panel
Governor's Office
Commissioner of Political Practices
State Auditor's Office

Health & Human Services

Lois Steinbeck (Ext. 5391, Office #118)

Marilyn Daumiller (Ext. 5386, Office # 108I)

Kris Wilkinson (Ext. 5834, Office #108B)

Natural Resources & Commerce

Barb Smith (Ext. 5347, Office #110A)

Fish, Wildlife & Parks
Environmental Quality
Natural Resources & Conservation

Shane Sierer (Ext. 5387, Office #108C)

Livestock
Agriculture
Commerce

Corrections & Public Safety

Pat Gervais (Ext. 1795, Office #130)

Board of Crime Control
Justice
Judiciary/Public Defender*
Public Service Regulation
Corrections

Shane Sierer (Ext. 5387, Office #108C)

Military Affairs
Labor & Industry

Education

Kris Wilkinson (Ext. 5834, Office #108B)

School for the Deaf and Blind
Board of Public Education
Montana Arts Council
Library Commission
Montana Historical Society

Education (cont.)

Alan Peura (Ext. 5387, Room 108D)

Commissioner of Higher Education/Board of Regents
Community Colleges
Six University Units and College of Tech.
Agricultural Experiment Station
Extension Service
Forestry & Conservation Experiment Station
Bureau of Mines & Geology
Fire Services Training School

Jim Standaert (Ext. 5389, Office #113)

Office of Public Instruction

Long Range Planning

Cathy Duncan (Ext. 4580, Office #110A)

Long-Range Building Program
State Building Energy Conservation
Treasure State Endowment
Treasurer State Endowment Regional Water System
Reclamation & Development Grant Program
Renewable Resource Grant & Land Program
Cultural and Aesthetic Grant Program

Revenue Estimating/Monitoring/Tax Policy

Terry Johnson (Ext. 2952, Office #115)

Jim Standaert (Ext. 5389, Office #113)

Roger Lloyd (Ext. 5385, Office #120)

Jim Standaert (Ext. 5389, Office #113)

Cathy Duncan (Ext. 4580), Office #130

Information Technology

Mike Allen (Ext. 4101, Office #110A)

Support Staff

Diane McDuffie (Ext. 2986, Office #110A)

Cassie Rice-Wetzel (Ext. 2986, Office #110A)

Fiscal Specialist

Jon Moe (Ext. 4581, Office #132)

Principal Fiscal Analysts

Terry Johnson (Ext. 2952, Office #115) – Revenue

Taryn Purdy (Ext. 5383, Office #114) - Budget

Legislative Fiscal Analyst & Director

Clayton Schenck, (Ext. 2988, Office #116)



INTRODUCTION

PURPOSE OF REPORT

The 59th Legislature was called into special session in December 2005 to deal with a proposal to add funding for K-12 education in order to comply with a court order that found the pre-2007 biennium level of funding inadequate. The session call also addressed the unfunded liability in Montana pension funds. The purpose of this report is to provide to the legislature:

- A summary of the Governor's special session call and the legislative response in special session
- Background information and legislative action on the school funding issue
- Background information and legislative action on the retirement systems unfunded liability issue
- A projection of general fund balance as of fiscal year end 2005, 2007 and 2009, including the revenue estimates as adopted by the Revenue and Transportation Interim Committee and introduced during the special session as HJ 1.

As noted throughout this report, there are a number of volatile economic conditions that may impact the final outcome of revenue and budget projections for the 2007 and 2009 biennia. Of primary concern is the uncertainty of individual income tax and oil and gas production collections, which have shown growth patterns that are unusual and need further analysis. This office will continue to monitor and update the legislature as needed should revenue projections or expenditure considerations change significantly during the remainder of this interim.

BACKGROUND – WHY A SPECIAL SESSION?

The 59th Legislature faced a daunting challenge in the 2005 regular session. In response to a December 2004 Supreme Court preliminary decision that declared the current method of funding K-12 education unconstitutional, the legislature was faced with the requirement to: 1) define a basic system of quality schools; 2) "cost out" the resources required to deliver a basic system of quality education; 3) develop a funding formula to distribute budget authority among school districts; and 4) develop the revenue stream to pay for the funding formula. The Supreme Court issued a final order in March 2005 affirming the district court's decision (Sherlock) that the legislature provide a plan to remedy the school-funding problem by October 1, 2005.

The 59th Legislature achieved the objective in the 2005 regular session of defining a basic system of quality schools, but decided that more time was needed to research and determine the costs of a basic system of quality education and to construct a funding formula for distribution of the state share of the cost. In SB 525, the Legislature established a Quality Schools Interim Committee (QSIC) to "assess the educational needs of Montana's children, determine the costs of a basic system of free quality public elementary and secondary schools, determine the state's share of the costs, and

construct a funding formula that equitably distributes the state's share of the costs of the basic system". The QSIC was charged to complete its work by December 1, 2005, with the understanding that a special session would be called, most likely in December 2005, to implement a plan and funding mechanism for schools that fully met requirements of the court order.

The QSIC commissioned a team of nationally recognized experts to conduct a study of the cost of an adequate K-12 education, and the results of their research showed that, using four different methods, the cost could require from \$0 to \$340 million in additional funding per year. Another study determined that teacher recruitment and retention was a problem for smaller schools. The committee then developed a new funding formula and adopted staff recommendations on consolidating funds, and directed staff to develop a bill reflecting the new funding formula. In its final form, the bill would have cost \$100 million more per year in base aid. The draft bill was not adopted by the QSIC, as they determined that the new formula required additional work.

On the same morning that the QSIC met to deliberate the draft bill (December 5), the Governor held a press conference and, citing that the QSIC had not agreed on its draft bill, declared that he would call the legislature into special session on December 14 to address the school funding issue as well as an unfunded liability in state defined benefit pension plans and other issues. The Governor proposed his own plan and funding formula for public schools to be considered by the legislature in special session.

THE GOVERNOR'S CALL

The Governor's call to the 59th Legislature for a December 2005 special session is presented in its entirety in Appendix A of this report.

In summary, The Governor's call limited the special session to the following issues:

1. Legislation to enact a funding system for public schools that is based on the definition of a quality education in SB 152 and that fulfills the requirements of the Supreme Court's decision in *Columbia Falls Elementary School vs. State of Montana*.
2. An appropriation for the schools funding system enacted in the special session in compliance with the Supreme Court's holding.
3. Appropriations of one-time general fund money to public schools for recognition of the cultural heritage of American Indians and for facility studies, weatherization for long-term energy savings, deferred maintenance, and assistance with utility and transportation energy costs.
4. An appropriation of \$100 million general fund to the teacher's retirement system and \$25 million to the public retirement system to reduce the unfunded liability of the systems.
5. To consider the State Administration and Veterans' Affairs Interim Committee sponsored bill (LC 2006-2) that provides for legislative committee monitoring of the state retirement systems and review of proposed pension system legislation.
6. A revenue estimate resolution as submitted by the Revenue and Transportation Interim Committee.
7. Confirmations of the chief water judge, the workers' compensation judge, and the Governor's vacancy appointment of the director of the Department of Public Health and Human Services.
8. The "feed bill" appropriation for the operations of the special session.



LEGISLATIVE ACTION IN SPECIAL SESSION - SUMMARY

SPECIAL SESSION HIGHLIGHTS

The Governor's budget proposal for appropriations to fund public schools and the retirement systems unfunded liability (items 2 through 4 in the session call) was \$190 million general fund (\$65 million for public schools and \$125 million for retirement systems unfunded liability) and was contained in House Bill 1. Ultimately, the legislature approved an additional \$197 million in general fund appropriations, including \$71.7 million added funding for public schools in the 2007 biennium (\$37.2 million of ongoing base funding and \$34.5 million in one-time funds) and \$125 million to be directly deposited to two of the retirement system funds to help reduce the total unfunded liability. The enacting legislation for a funding system for public schools was incorporated in SB 1. The legislature also passed HB 2, which provides for legislative committee monitoring of state retirement systems and legislative review of proposed pension system legislation.

Although the revenue estimating resolution did not get to the floor of either house for a vote, the revenue estimates contained in the resolution were adopted by the Revenue and Transportation Interim Committee and introduced in the session, which by statute gives the estimates standing as the official legislative estimates. With the revenue estimates in HJR1 and the additional spending approved in special session, the projected ending fund balance in the general fund for the 2007 biennium is \$228.6 million.

Details of the legislation approved in special session are summarized in this section and are discussed in greater detail in the subsequent chapters of this report. The general fund summary and projected ending fund balance are discussed in the final chapter.

PUBLIC SCHOOL FUNDING

The legislature increased ongoing funding for public schools by \$37.2 million in FY 2007. The legislature also appropriated \$34.5 million in one-time funding - \$4.5 million in FY 2006 and \$30.0 million in FY 2007. Figure 1 summarizes legislative action.

| Figure 1 Public School Funding Summary of Legislative Action | | | |
|---|--------------------|---------------------|---------------------|
| | FY 2006 | FY 2007 | Biennium |
| Ongoing Funding | | | |
| Total Quality Educator Component | \$0 | \$24,316,000 | \$24,316,000 |
| Total Quality Educator Component (DOC and MSDB) | 0 | 148,800 | 148,800 |
| Close American Indian Achievement Gap Component | 0 | 3,279,200 | 3,279,200 |
| Indian Education For All Component | 0 | 3,002,430 | 3,002,430 |
| At Risk Component (Based on Title I Formula) | 0 | 5,000,000 | 5,000,000 |
| Increase Individual Transportation Contracts (\$0.25/mi to \$0.35/mi) | 0 | 130,000 | 130,000 |
| Retirement Impact (County) | 0 | 1,340,785 | 1,340,785 |
| Total On going Funding Provisions | \$0 | \$37,217,215 | \$37,217,215 |
| One-Time Only Funding | | | |
| Indian Education for All Component | \$0 | \$7,000,000 | \$7,000,000 |
| Building Operation and Maintenance | 0 | 23,000,000 | 23,000,000 |
| Energy Cost Relief | 2,000,000 | 0 | 2,000,000 |
| Facility Condition Inventory (Dept of Admin) | 2,500,000 | 0 | 2,500,000 |
| Total One-Time Funding Provisions | \$4,500,000 | \$30,000,000 | \$34,500,000 |
| Total Public School Funding | \$4,500,000 | \$67,217,215 | \$71,717,215 |

See "Public Schools Funding Action" on page 7 for more details on legislative action.

RETIREMENT SYSTEMS UNFUNDED LIABILITY

The legislature enacted two bills related to retirement systems. HB 1, the bill that provided for the funding of K-12 schools, also contained two line items that appropriated \$100 million general fund to the Teachers' Retirement System and \$25 million general fund to the Public Employees' Retirement System. This action was characterized as a "first step" by the legislature toward solving the unfunded liability problem. There is still a significant actuarial unfunded liability that the 60th Legislature will face when it convenes in January of 2007.

HB 2, which was recommended by the State Administration and Veterans Affairs (SAVA) Interim Committee, provides the SAVA committee with additional duties of monitoring the actuarial soundness of the retirement systems and reviewing legislative proposals that might affect the soundness of those systems. The bill included an appropriation of \$5,000 general fund to cover the cost of a couple of extra meeting days for the SAVA committee during the 2005-2006 interim. This legislation restored a monitoring function to the legislature that had been in place in the 1990's, but was discontinued.

Of the \$1.46 billion reported unfunded liability preceding the special session, \$722 million was needed to bring the retirement plans into compliance with the constitutional and statutory requirement to be actuarially sound. In the session, the legislature appropriated \$125 million, leaving a balance of \$597 million to be addressed, assuming that the numbers do not change. However, it is likely that the unfunded liability will grow further as there is not enough revenue going into the system to pay down the liability or to even keep it stable. There is still hope that investment returns and other factors might outperform the assumptions applied in the actuarial valuations, and contribute some positive impacts on the condition of these retirement systems.

The challenge for a future legislature is to craft a solution that will return the retirement plans to an actuarially sound condition in compliance with the constitutional and statutory requirement.

See "Retirement Systems Unfunded Liability" on page 15 for more details on legislative action.



PUBLIC SCHOOLS FUNDING ACTION

BACKGROUND

In March 2005, the Montana Supreme Court unanimously upheld the April 2004 district court decision (the Sherlock Decision) that found the K-12 funding system unconstitutional. This was because the legislature did not define a basic system of quality elementary and secondary schools, didn't have a school funding formula based on educationally relevant factors and because the legislature had not adequately funded education of all Montana children in the cultural heritage of American Indians.

In response to the court ruling, the 2005 Legislature did the following:

1. Defined a basic system of quality elementary and secondary schools in SB 152.
2. Created the Quality Schools Interim Committee in SB 525 to devise a new funding formula that reflects the new definition and determines the state share of K-12 funding.
3. Appropriated \$3.4 million for Indian Education for All.
4. Appropriated \$68.8 million in additional Base Aid for the FY 2007 biennium above FY 2004 levels by increasing the per ANB entitlements by \$250 per elementary ANB and by \$100 per high school ANB, instituting three-year averaging of ANB; and applying inflation to the basic and per ANB entitlements.
5. Appropriated an additional \$16.5 million for other categorical programs.

QUALITY SCHOOLS INTERIM COMMITTEE

The Quality Schools Interim Committee (QSIC) created in SB 525 met 21 times after the end of the 2005 session and accomplished the following:

1. Commissioned a team of nationally recognized experts to conduct a study of the cost of an adequate K-12 education using four methods. The results showed that the K-12 system requires between \$0 and \$340 million in additional funding.
2. Commissioned a team of economists from Montana State University to study teacher recruitment and retention problems in Montana. The study found recruitment and retention problems for small schools but not for large schools.
3. Directed staff to develop a new funding formula comprising six general fund components (including a per student component, a classroom component, an accredited program component, an operations and maintenance component, a special education component, and an Indian education for all component), and three non-general fund components (a debt service component, a capital projects component, and a transportation component);
4. Adopted staff recommendations on consolidating funds.
5. Directed staff to draft a bill reflecting its work in developing a new funding formula based on educationally relevant factors.

In its final form, the new formula would have cost the state \$100 million more per year in Base Aid. Some of the features of the new formula were adopted in modified form in the Governor's proposal, and in final legislative action.

Although the QSIC accomplished the requirements contained in SB 525, the committee determined that the new funding formula developed required more work and time to refine the formula. The Governor instead chose to submit his own proposal and called a special session to deal with public school funding.

DETAILED SUMMARY OF LEGISLATIVE ACTION

On December 14th and 15th, 2005, the legislature met in response to the Governor's call for a special session on K-12 funding and retirement issues. The Governor had proposed increasing funding by \$31.4 million in ongoing support for K-12 and \$33.5 million in one-time only support, for a total of \$64.9 million. The legislature adopted the Governor's proposal but also added \$5.7 million in ongoing funds and \$1.0 million in one-time support, as shown in Figure 1. The total biennial increase in funding for public schools (including other agencies) as a result of legislative action in the special session is \$71.7 million. The school districts' share is \$67.7 million and \$1.3 million is for county teachers' retirement, while the increase for the Department of Administration is \$2.5 million and for the Department of Corrections and the Montana School of Deaf and Blind is \$148,800.

Figure 1

Comparison of Legislative Action with Executive Proposal - 2005 Special Session - State General Fund and Guarantee Account For Fiscal 2007

| | Executive FY 2007 | Legislative FY 2007 | Difference |
|---|----------------------|------------------------|--------------------|
| Ongoing Funding | | | |
| Total Quality Educator Component | \$23,122,000 | \$24,316,000 | \$1,194,000 |
| Total Quality Educator Component (DOC and MSDB) | 0 | 148,800 | 148,800 |
| Close American Indian Achievement Gap Component | 1,639,600 | 3,279,200 | 1,639,600 |
| Indian Education For All Component | 3,002,430 | 3,002,430 | 0 |
| At Risk Component (Based on Title I Formula) | 2,500,000 | 5,000,000 | 2,500,000 |
| Increase Individual Transportation Contracts (\$0.25/mi to \$0.35/mi) | 0 | 130,000 | |
| Retirement Impact (County) | 1,139,895 | 1,340,785 | 200,890 |
| Total Ongoing Funding Provisions | \$31,403,925 | \$37,217,215 | \$5,683,290 |
| One-Time Only Funding | | | |
| Indian Education for All Component | \$7,000,000 | \$7,000,000 | \$0 |
| Building Operation and Maintenance | 22,998,633 | 23,000,000 | 1,367 |
| Energy Cost Relief (Legislative action is for FY 2006) | 1,008,053 | 2,000,000 | 991,947 |
| Facility Condition Inventory (Dept of Admin) (FY 2006) | 2,500,000 | 2,500,000 | 0 |
| Total One-Time Funding Provisions | \$33,506,686 | \$34,500,000 | \$993,314 |
| Total K-12 Proposal | \$64,910,611 | \$71,717,215 | \$6,676,604 |
| Distribution | | | |
| Total Distributed to School Districts | 61,270,716 | 67,727,630 | 6,326,914 |
| Total Distributed to Counties (Retirement) | 1,139,895 | 1,340,785 | 200,890 |
| Total Distributed to Dept of Admin (FCI Study) | 2,500,000 | 2,500,000 | 0 |
| Total Distribute to Corrections and Mt School of Deaf & Blind | 0 | 148,800 | 148,800 |
| Total Distribution | \$64,910,611 | \$71,717,215 | \$6,676,604 |

The legislature passed SB 1, which contained all of the policy initiatives. HB 1 contained the appropriations for both the ongoing and one-time initiatives.

ONGOING FUNDING

The new ongoing K-12 funding components created in SB 1 are shown in Figure 2. The new ongoing components are:

1. Creation of a quality educator component in FY 2007 in the district general fund at \$2,000 per educator for all districts and cooperatives. The state's cost is \$24.3 million, with no local share. The quality educator component is for all licensed educators in each district and in each special education cooperatives. Licensed educators include teachers, administrators, and support personnel, but excludes paraprofessionals. There were 12,158.0 licensed educators statewide in the Fall of 2005. The quality educator money is also available for teachers at Pine Hills and Riverside and is to be distributed by the Department of Corrections (\$63,800 in FY 2007) and to the Montana School of Deaf and Blind (\$85,000 in FY 2007).
2. Creation of a component to close the American Indian achievement gap in FY 2007 - \$3.28 million. This will be distributed to districts with American Indian students of which there are 16,396 in FY 2006. The per Indian student amount is \$200.
3. Creation of a component for Indian Education for All in FY 2007- \$3.0 million. The proposal distributes \$20.40 for every ANB in the state, with a minimum of \$100 per district. There are expected to be 147,161 ANB in FY 2007.
4. Creation of a component for at-risk children in FY 2007- \$5.0 million. This component will be distributed based on the formula by which federal Title I monies are distributed. The Title I formula is based on the percentage of children in a district below the federal poverty line.
5. If the dollars associated with the above components are used by districts for new hires or for salary increases, there will be a need for increased social security, Medicare, workers compensation, and teachers retirement contributions. At maximum, this could total \$5.0 million, of which the state share is \$1.3 million and the portion paid for by county property taxes is \$3.7 million.
6. Abolishment of the sunset date of June 30, 2007 for ending the three year averaging of ANB. The proposal also makes permanent the per ANB increases in HB 63 enacted in the 2005 regular session. HB 63 increased the FY 2005 per ANB entitlements for FY 2006 by \$250 per elementary ANB and by \$100 per high school ANB, but also sunset these provisions at the end of FY 2007 by returning the per ANB entitlements to FY 2005 levels. SB 1 abolishes this sunset and makes the increases for FY 2006 permanent.
7. Increase in the reimbursement rates for individual transportation contracts from \$0.25 per mile to \$0.35 per mile beginning in FY 2007. This will cost the state \$130,000, and local taxpayers an additional \$130,000 statewide.

None of the new ongoing funding in SB 1 for FY 2007 will be adjusted for inflation in future biennia. The basic and per ANB entitlements continue to be subject to inflationary increases in future biennia.

As shown in Figure 2, the legislative actions in SB 1 increase state costs for K-12 by \$37.1 million. In the third panel of Figure 2, are the general fund appropriations for ongoing costs, which are contained in HB 1. The general fund appropriations for ongoing K-12 costs total only \$33.8 million. The difference, \$3.3 million, will reduce K-12 state general fund reversions that were expected to total \$12.1 million during the 2007 biennium. This is because of higher royalty revenues from oil and natural gas production on school lands. These revenues are expected to be higher than the estimate made during the regular session, and thus will lower expected general fund costs for K-12 during the 2007 biennium.

| Figure 2 | | | | | |
|---|--------------------------|---------------|---------------------|---------------------|---------------------|
| Provisions of SB 1 and HB 1 - K-12 Proposal - FY 2007 | | | | | |
| | Units | Cost per Unit | Total Cost | State Share | Local Share |
| Ongoing Funding For K-12 | | | | | |
| BASE Aid | | | | | |
| Quality Educator Component | | | | | |
| All Districts and coops, based on licensed educators | 12,158.0 | \$2,000 | \$24,316,000 | \$24,316,000 | \$0 |
| Close American Indian Achievement Gap Component | 16,396 | 200 | 3,279,200 | 3,279,200 | 0 |
| Indian Education For All Component | 147,161 | 20.40 | 3,002,430 | 3,002,430 | 0 |
| At Risk Component (Based on Title I Formula) | | | 5,000,000 | 5,000,000 | 0 |
| Retirement Impact (Countywide Retirement Account) | | | <u>4,965,869</u> | <u>1,340,785</u> | <u>3,625,085</u> |
| Total BASE Aid (Ongoing) | | | <u>\$40,563,499</u> | <u>\$36,938,415</u> | <u>\$3,625,085</u> |
| Transportation Increase (Individual Contracts from \$0.25/Mi to \$0.35/Mi) | | | <u>260,000</u> | <u>130,000</u> | <u>130,000</u> |
| Total Non- BASE Aid for K-12 | | | <u>\$260,000</u> | <u>\$130,000</u> | <u>\$130,000</u> |
| Total K-12 Cost of SB 1- (Ongoing) | | | <u>\$40,823,499</u> | <u>\$37,068,415</u> | <u>\$3,755,085</u> |
| One-Time Only Funding - K-12 | | | | | |
| Indian Education for All Component | 147,161 | \$47.57 | \$7,000,000 | \$7,000,000 | \$0 |
| Building Operation and Maintenance | \$1,000/Dist - \$153/ANB | | 23,000,000 | 23,000,000 | 0 |
| Energy Cost Relief (biennial approp begins in FY 2006, Misc Pgms Fnd) | 147,161 | \$13.70 | 2,000,000 | 2,000,000 | 0 |
| Facility Condition Inventory (Dept of Admin) | | | <u>2,500,000</u> | <u>2,500,000</u> | <u>0</u> |
| Total One-Time Funding Provisions | | | <u>\$34,500,000</u> | <u>\$34,500,000</u> | <u>\$0</u> |
| Total Ongoing and One-Time Funding Provisions FY 2007 | | | <u>\$75,323,499</u> | <u>\$71,568,415</u> | <u>\$3,755,085</u> |
| Appropriations in HB1 For K-12 and Other Agencies | | | | | |
| | | | | State | State |
| K-12 BASE Aid Ongoing Appropriation in HB 1 | | | | \$28,668,278 | |
| Ongoing Appropriations in HB 1 for At Risk and Transportation | | | | <u>5,130,000</u> | |
| Total Ongoing Appropriations in HB 1 for K-12 | | | | | \$33,798,278 |
| Difference between SB 1 and Appropriation Authority in HB 1=Reduction in Reversions (3,270,137) | | | | | |
| One-Time Only Appropriations | | | | | \$34,500,000 |
| Ongoing Quality Educator (Corrections) | | | | 63,800 | |
| Ongoing Quality Educator (MSDB) | | | | <u>85,000</u> | |
| Total to DOC and MSDB | | | | | \$148,800 |
| Total Appropriations HB 1 | | | | | \$68,447,078 |
| Total Appropriated to School Districts & Countywide Retirement | | | | \$65,798,278 | |
| Total Appropriated to DOC and MSDB | | | | 148,800 | |
| Total Appropriated to Dept of Admin (FCI Study) | | | | <u>2,500,000</u> | |
| Total Appropriations in HB 1 | | | | | <u>\$68,447,078</u> |

Figure 3 shows a comparison of legislative action with respect to ongoing K-12 funding for FY 2007 during the regular session and the special session. As a result of action in both sessions, FY 2007 funding for K-12 (including statutory appropriations of interest and income from school lands) will exceed actual spending on K-12 in FY 2004 by \$81.0 million, an increase of 14.5 percent.

Figure 3

Comparison of Legislative Action for Fiscal 2007 to Base Fiscal 2004, Ongoing K-12 Funding
(Amounts in Millions)

| State Aid to K-12 | Fiscal 2004 Base | Regular Session Fiscal 2007 Appropriations | Increase in Fiscal 2007 over Fiscal 2004 Base - Regular Session | Sum of Fiscal 2007 Appropriations - Both sessions | Increase in Total Appropriations - Fiscal 2007 less Fiscal 2004 | Percent Increase Over Fiscal 2004 |
|--|---------------------|--|--|--|--|--------------------------------------|
| Base Aid | \$449.5 | \$485.5 | \$35.9 | \$485.5 | \$35.9 | |
| Special Ed | 34.9 | 39.3 | 4.5 | 39.3 | 4.5 | |
| School Facilities | 8.3 | 10.4 | 2.1 | 10.4 | 2.1 | |
| Other (HB 124 BG, Vo-Ed, Gifted & Talented) | 64.2 | 66.1 | 1.9 | 66.1 | 1.9 | |
| Per Educator | 0.0 | 0.0 | 0.0 | 24.3 | 24.3 | |
| Close American Indian Achievement Gap | 0.0 | 0.0 | 0.0 | 3.3 | 3.3 | |
| Indian Education For All Component | 0.0 | 0.6 | 0.6 | 3.0 | 2.5 | |
| At Risk Component (Based on Title I Formula) | 0.0 | 0.0 | 0.0 | 5.0 | 5.0 | |
| Transportation Contract Increase | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | |
| Retirement Impact (County) | 0.0 | 0.0 | 0.0 | 1.3 | 1.3 | |
| Total State Funding | <u>\$556.9</u> | <u>\$601.9</u> | <u>\$45.0</u> | <u>\$638.4</u> | <u>\$81.0</u> | <u>14.5%</u> |

Note: Base Aid includes the amounts appropriated from the state general fund and expected revenue from guarantee account

ONE-TIME FUNDING

The legislature, in HB 1, appropriated \$34.5 million in one-time-only general fund monies. \$2.0 million of this amount in FY 2006 is for energy cost relief and \$2.5 million is for a facility condition inventory. The remainder (\$30.0 million) of one-time funding is in FY 2007. In detail, these appropriations are for the following:

1. Creation of a component for Indian Education for All for FY 2007 - \$7.0 million. This component is distributed at \$47.57 for every ANB in the state.
2. Creation of a component for building operation and maintenance (for weatherization and deferred maintenance and an energy audit) for FY 2007 - \$23.0 million. This component is distributed \$1,000 per district and \$153 per ANB.
3. Creation of a component for energy cost relief for FY 2006 - \$2.0 million. This component is distributed at \$13.70 for every ANB in the state and may be used for fuel costs or other energy needs.
4. Allocation of \$2.5 million to the Department of Administration (DOA) for the costs of conducting a school facility condition and needs assessment and an energy audit of each school building in the state. DOA will work with the Legislative Finance Committee to design the process for collecting and analyzing the related data. The findings of the assessment and energy audit will be presented to the legislature no later than July 1, 2008.

LFD COMMENT

The Department of Administration, Architecture and Engineering Division (A&E), will oversee the school facility condition and needs assessment and energy audit. The \$2.5 million appropriation provides funding of \$188,000 to A&E for 1.5 FTE for project oversight and \$2.3 million for the costs associated with a contract for the facility condition and needs assessment. HB 1 tasked the LFC to work with A&E to design the assessment study, which will not begin until January 2007 per the fiscal note. Because no funding was included for the energy audit component of the study and the inflation effects of delaying the start up of the study until January 2007, A&E and the LFC may be required to consider reducing the scope of the study.

DID LEGISLATIVE ACTION ADDRESS COURT REQUIREMENTS?

In two sessions, the 59th Legislature increased ongoing state funding for K-12 in the 2007 biennium compared with FY 2004 levels by \$122.2 million (\$40.2 million for FY 2006 plus \$81.0 million for FY 2007) and appropriated \$34.5 million in one-time funding (\$31.5 million for districts and \$2.5 million for the facility condition inventory). Will this satisfy the requirements of the decision by Judge Sherlock in *Columbia Falls et.al v Montana*, as well as the plaintiffs to that case? This is very difficult question to answer. The Sherlock decision states that a phase-in, perhaps of several years, is acceptable. The plaintiffs in the case have, as of this writing, indicated whether they will seek further court remedies.

The Sherlock decision ruled that the current K-12 funding formula (containing a basic entitlement and a per ANB entitlement) was unconstitutional because: 1) it was based on spending data two years old at its implementation; 2) the entitlement amounts were not based on educationally relevant factors; 3) it relies too much on ANB; and 4) it contains no inflation factor. The 59th Legislature's actions did not change the components of the current formula but instead augmented the current formula by adding four new components paid for with state money. This, in part, mitigates item 1 above by adding money that partially makes up for past inflationary shortfalls. In addition, the passage of SB 152, which defines a basic system of quality education, addresses issue 2 above. In spite of the failure of the QSIC to pass a new funding formula, the new components developed during the special session were devised to be defensible in court because they address a portion of the definitions of a basic system of quality education in SB 152. Also, the legislature in the 2003 session added provisions to inflate the entitlements starting in FY 2006 and continuing in future biennia. Also in the 2005 legislative session, the legislature adopted three-year averaging of ANB, which attempts to address the problem of declining enrollment. The creation of an educator component will further add to funding stability. Finally the legislature, in creating new components that target at-risk and American Indian students, has directed funds to those districts challenged with low achievement.

The full resolution of how to define a basic system of quality education and how to fund it will likely remain a point of contention for a long period of time, as it has been in most other states. Future increases in K-12 funding are likely to be large by historical standards. With the addition of the ongoing money approved during the 2005 special session, as well as inflationary increases (adjusted for further ANB declines), the present law adjustments above the FY 2006 base for FY 2008 and FY 2009 will be around \$102 million when the legislature convenes in session in January 2007. Any new law additions of equal size as those passed by the 2005 session will add an additional \$111 million in new proposals.

APPROPRIATIONS FOR THE 2007 BIENNIUM

Figure 4 shows K-12 appropriations for FY 2006 and 2007 as a result of action in the regular session and the special session by the 59th Legislature.

| Figure 4 | | | | | | |
|---|------------------------------|----------------------|---|----------------------|--------------------|---------------------|
| Appropriations to Schools, General Fund, State Special, and Federal Funds - 2007 Biennium | | | | | | |
| Description | Appropriated Regular Session | | Appropriated - Regular and Special Sessions | | Difference | |
| | Fiscal 2006 | Fiscal 2007 | Fiscal 2006 | Fiscal 2007 | Fiscal 2006 | Fiscal 2007 |
| State Base Aid Funding - All Funds | | | | | | |
| Direct State Aid (State General Fund and Guarantee Account Interest & Income) | \$347,564,542 | \$349,043,617 | \$347,564,542 | \$349,043,617 | \$0 | \$0 |
| General Fund GTB | 111,475,186 | 112,574,142 | 111,475,186 | 112,574,142 | 0 | 0 |
| Retirement GTB | 22,987,772 | 23,873,741 | 22,987,772 | 23,873,741 | 0 | 0 |
| 4 New Ongoing Components | 0 | 0 | 0 | 33,668,278 | 0 | 33,668,278 |
| Total Base Aid | <u>\$482,027,500</u> | <u>\$485,491,500</u> | <u>\$482,027,500</u> | <u>\$519,159,778</u> | <u>\$0</u> | <u>\$33,668,278</u> |
| General Fund | | | | | | |
| Direct State Aid | \$297,991,366 | \$299,924,665 | \$297,991,366 | \$299,924,665 | \$0 | \$0 |
| GTB - School General Fund | 111,475,186 | 112,574,142 | 111,475,186 | 112,574,142 | 0 | 0 |
| GTB - School Retirement | 22,987,772 | 23,873,741 | 22,987,772 | 23,873,741 | 0 | 0 |
| 4 New Components - Base Aid | 0 | 0 | 0 | 33,668,278 | 0 | 33,668,278 |
| Special Education | 38,506,122 | 39,348,289 | 38,506,122 | 39,348,289 | 0 | 0 |
| Transportation | 12,142,550 | 12,242,550 | 12,142,550 | 12,372,550 | 0 | 130,000 |
| School Facility Reimbursement | 10,399,135 | 10,399,135 | 10,399,135 | 10,399,135 | 0 | 0 |
| Instate Treatment | 974,896 | 974,896 | 974,896 | 974,896 | 0 | 0 |
| Secondary Vo Ed | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 0 | 0 |
| Adult Basic Ed | 275,000 | 275,000 | 275,000 | 275,000 | 0 | 0 |
| Gifted & Talented | 250,000 | 250,000 | 250,000 | 250,000 | 0 | 0 |
| School Food | 648,653 | 648,653 | 648,653 | 648,653 | 0 | 0 |
| Other | 151,356 | 154,370 | 151,356 | 154,370 | 0 | 0 |
| HB 124 Block Grants | 50,213,191 | 50,594,815 | 50,213,191 | 50,594,815 | 0 | 0 |
| Indian Education For All | 550,000 | 550,000 | 550,000 | 550,000 | 0 | 0 |
| Indian Education for All OTO | 0 | 0 | 0 | 7,000,000 | 0 | 7,000,000 |
| Building Operation & Maintenance OTO | 0 | 0 | 0 | 23,000,000 | 0 | 23,000,000 |
| Energy Cost Relief OTO | 0 | 0 | 2,000,000 | 0 | 2,000,000 | 0 |
| Total General Fund | <u>\$547,565,227</u> | <u>\$552,810,256</u> | <u>\$549,565,227</u> | <u>\$616,608,534</u> | <u>\$2,000,000</u> | <u>\$63,798,278</u> |
| State Special Revenue | | | | | | |
| Traffic Safety Distribution | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$0</u> | <u>\$0</u> |
| Total State Special | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$750,000</u> | <u>\$0</u> | <u>\$0</u> |
| Funding | | | | | | |
| Total General Fund | \$547,565,227 | \$552,810,256 | \$549,565,227 | \$616,608,534 | \$2,000,000 | \$63,798,278 |
| Total State Special | 750,000 | 750,000 | 750,000 | 750,000 | \$0 | \$0 |
| Total Federal Special | 133,537,139 | 140,457,910 | 133,537,139 | 140,457,910 | \$0 | \$0 |
| Total Distribution to Public Schools | <u>\$681,852,366</u> | <u>\$694,018,166</u> | <u>\$683,852,366</u> | <u>\$757,816,444</u> | <u>\$2,000,000</u> | <u>\$63,798,278</u> |
| Statutory Appropriations | | | | | | |
| Guarantee Account - Interest & Income | \$49,573,176 | \$49,118,952 | \$56,856,405 | \$54,828,651 | \$7,283,229 | \$5,709,699 |
| Guarantee Account -Timber | <u>1,700,000</u> | <u>1,700,000</u> | <u>1,700,000</u> | <u>1,700,000</u> | <u>0</u> | <u>0</u> |
| Total Statutory | <u>\$51,273,176</u> | <u>\$50,818,952</u> | <u>\$58,556,405</u> | <u>\$56,528,651</u> | <u>\$7,283,229</u> | <u>\$5,709,699</u> |



RETIREMENT SYSTEMS UNFUNDED LIABILITY

INTRODUCTION

The Governor's special session call included three items related to the public employee retirement systems:

- An appropriation of \$100 million from the general fund to the teachers' retirement system to both reduce the unfunded liability of the system and to help improve Montana's ability to recruit and retain qualified teachers
- An appropriation of \$25 million from the general fund to the public retirement system to help reduce the unfunded liability of the system
- LC 2006-2, approved by the State Administration and Veterans' Affairs (SAVA) Interim Committee on November 30, 2005

The legislature enacted two bills that included this \$125.0 million general fund for the retirement system and gave the SAVA committee authority to monitor the retirement plans as specified in LC 2006. The following sections provide background information, a description of the legislative actions in the December 2005 Special Session, and a discussion of what was accomplished and what remains to be done, including some of the options for the future.

BACKGROUND

UNFUNDED LIABILITY OF PERS, TRS, SRS, AND GWPORS

The issue before the legislature in the special session was the unfunded liabilities in the following retirement systems:

- PERS – Public Employees' Retirement System
- TRS – Teachers' Retirement System
- SRS – Sheriffs' Retirement System
- GWPORS – Game Wardens' and Peace Officers' Retirement System

An "unfunded liability" refers to the excess of a retirement plan's *actuarial liability* over the *actuarial value of assets*. *Actuarial liability* is the amount that the retirement system expects to pay out over the long-term. *Actuarial value of assets* is the amount that the retirement system expects to have available to pay retirement obligations over the long-term. Both components of the equation are based upon many assumptions.

Unfunded liabilities are reported for retirement systems other than the four listed above, but the amortization period for those other systems is less than 30 years as required in statute. In simpler terms, this means that the actuarial unfunded liability for the other systems is calculated to theoretically disappear in less than 30 years. The Judges' Retirement System is the only plan that does not have an unfunded liability. The four retirement systems listed above, on the other hand, have actuarial unfunded liabilities that are not amortized in less than 30 years, as Montana statute requires for the retirement plan to be actuarially sound.

HOW MUCH WAS THE UNFUNDED LIABILITY?

Based on the actuarial valuations prepared as of June 30, 2005, the total unfunded actuarial liability for the four systems preceding the special session was estimated at \$1.46 billion. Broken out by retirement plan, the unfunded liabilities are as follows:

- PERS - \$541.8 million
- SRS - \$10.9 million
- GWPORS - \$5.5 million
- TRS - \$903.3 million

Article VIII, Section 15 of the Montana Constitution provides that “Public retirement systems shall be funded on an actuarially sound basis”. This constitutional requirement drives the need for the state to address the issue of an unfunded liability to insure that funds are available in the future to meet the obligations of future benefits as determined by actuarial valuations of the retirement systems. This requirement is further defined in Section 19-2-409, MCA:

“...“actuarially sound basis” means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years.”

To satisfy the 30-year amortization requirement, the legislature does not need to provide the entire \$1.46 billion. What is needed is a plan to reduce the unfunded liability to a level that can be amortized within the 30 years, either by increasing the system’s assets (cash infusion), increasing the revenue into the system (contributions or investment earnings), and/or reducing the expenditures from the system (reducing benefits). The solution must provide a plan to pay down the unfunded liability within 30 years, and the retirement funds could then be viewed as “actuarially sound”.

WHERE DID THE UNFUNDED LIABILITY COME FROM?

Investment losses are the primary reason for the current unfunded liability problem. In the period of 2001 through 2003, those returns were much lower than projected, and in two of the three years were negative. The drop in value of the equity market (stocks) is the major culprit.

To the extent that reported actuarial surpluses were used up by the passage of benefit enhancement legislation without increased contributions to fund them, unfunded retirement benefit increases have contributed to the present situation. Such legislation was enacted in the years preceding the decline in the equity markets, particularly legislation that increased the guaranteed annual benefit adjustment (GABA) to its current level of 3 percent per year in all systems except the Teachers’ Retirement System, which is 1.5 percent.

LFD COMMENT

The GABA legislation had its roots in the 1991 session when the legislature created an interim committee to examine public retirement issues and especially to develop a proposal to provide postretirement adjustments to public retirees. Although a bill to provide postretirement increases was introduced in the 1993 session and in the 1995 session, each failed. In 1997, the legislature adopted HB 170, which provided a 1.5 percent GABA for public retirement systems administered by the Public Employees’ Retirement Board. In 1999, the legislature adopted HB 72 granting TRS retirees a 1.5 percent GABA. In 2001 the GABA for the seven defined benefit retirement systems administered by the Public Employees’ Retirement Board was increased from 1.5 percent to 3.0 percent.

It should be pointed out that investment gains, contribution rate increases, and reamortization of unfunded liabilities have historically been used by legislatures all across the country to fund benefit enhancements. Montana is not alone in funding benefits using enhanced market values, nor is it alone in having experienced significant investment losses. Montana is also not the only state seeking solutions to actuarially fund its public pension plans.

SAVA COMMITTEE RECOMMENDATIONS

In the 2005 legislative session, the State Administration and Veterans' Affairs (SAVA) interim committee was assigned the study related to investments and the unfunded liability that was directed in HJR 42. Within the context of this study, the SAVA committee developed recommendations to address the "unfunded liability" problem, in the form of two bill drafts:

- LC2006-2 - This bill directs the SAVA interim committee to monitor the soundness of the state's public retirement systems and to review all legislative proposals for statutory changes. The bill details the additional duties and responsibilities of the committee and provides a \$5,000 general fund appropriation to fund the increased costs for the committee to meet for an additional two days. The added duties and responsibilities mirror those of the Committee on Public Employees' Retirement Systems that existed from 1993 through 1998. The SAVA committee concluded that this function should be reestablished with the legislature to ensure that the legislature has the opportunity to review retirement system proposals. This bill draft was specifically included in the Governor's special session call and was introduced as HB 2.
- LC2005-4 - This bill would provide the statutory changes and appropriate funds necessary to achieve the actuarial soundness of the four public retirement systems. The bill addresses the unfunded liability in three ways:
 - Appropriations to provide an infusion of cash into the four retirement plans in FY 2006 – totaling \$125 million general fund (as drafted), \$100 million of which is earmarked for the teachers' system. The bill would appropriate \$10.9 million to the PERS defined benefits plan, \$11.5 million to the SRS, \$1.2 million to the GWPORS, and \$1.4 million to be used for repaying the loan for startup costs of the defined benefits plan.
 - Increases in employer contribution rates for three systems beginning July 1, 2006 (note that the employer rate for the GWPORS is not increased because the \$1.2 million that is paid into that system provides an amount needed to reduce the unfunded liability to a level where the plan is actuarially sound). Several sections provide for the employer contribution rate increases for PERS, SRS, and TRS plans. For the SRS, there is a single rate increase beginning July 1, 2006, from 9.535 percent to 10.205 percent, along with a cash infusion of \$11.5 million. For the PERS and the TRS plans, the employer rate increases are phased in beginning July 1, 2006. These rate increases would stay in place until eliminated or changed by the legislature based upon actuarial valuations for the retirement plans, showing that the plans were actuarially sound. Within the appropriations clause is a placeholder for appropriations to fund these rate increases.
 - Housekeeping modifications to close loopholes in the retirement laws that increase the unfunded liability.

In all, this bill (LC2005-4) would provide a financial solution to the current unfunded actuarial liability (UAL) issue by putting a plan in place to bring the amortization period for the UAL to within 30 years. However, only a portion of this bill was included in the special session call, that being the cash infusion of \$125 million general fund ultimately included in HB 1. The remaining proposals in the bill were not addressed in the special session.

SPECIAL SESSION LEGISLATIVE ACTION

For the special session, the Governor's special session call presented a fairly straightforward first step toward resolving the unfunded liability issue. Two retirement related proposals were enacted.

First, the call suggested enactment of legislation (LC2006-2) to give the State Administration and Veterans Affairs (SAVA) interim committee the additional duties and responsibilities relative to the monitoring of the public employee retirement systems. The legislation proposed by the SAVA committee proposed legislation was introduced and enacted as HB 2 and was only slightly amended. It includes an appropriation of \$5,000 general fund to fund a couple of additional meeting days for the SAVA committee during the 2005-2006 interim.

Second, in response to the call, the legislature appropriated \$125 million general fund to reduce the unfunded liability of the retirement plans. This appropriation is in two line items listed in HB 1, the bill that was the vehicle for the school funding appropriations as well as the retirement appropriations. In one item, the legislature appropriated \$100 million from the general fund to the Teachers' Retirement System. In another line item, the legislature appropriated \$25 million from the general fund to the Public Employees' Retirement System. The unfunded liabilities of the Sheriffs' Retirement System, the Game Wardens' and Peace Officers' Retirement System, and the payoff of the startup loan suggested by the SAVA committee bill were not addressed by the Governor's call or legislative action.

LFD COMMENT

A call by a governor for a special session is purposefully limited for various reasons. As pointed out, the two call items related to the unfunded liability issue represented only part of the solution that was recommended by the State Administration and Veterans Affairs (SAVA) interim committee in its November 30, 2005 meeting. Besides the \$125 million general fund cash infusion, the legislation proposed by the SAVA committee included the phasing-in of employer contribution rate increases and changes to statute that would close some loopholes in the calculation of benefit levels. The cost of the phased-in employer rates was estimated at about \$15.3 million all funds in FY 2007, \$31.6 million in FY 2008, \$32.8 million in FY 2009, \$41.0 million in FY 2010, and then a more normal growth of about 4.5 percent after that for many years thereafter. The legislature will be faced with this issue again in the next regular session as the unfunded liabilities of the four plans need to be reduced considerably more in order to get it down to a level that can be amortized within the 30-year period required by statute for an actuarially sound retirement plan.

REVISED UNFUNDED LIABILITY

The actions of the legislature in the December 2005 special session reduced the unfunded liability by the amount of the cash infusion into the two systems that were addressed. Figure 1 shows the before and after session status of the four retirement plans that are actuarially unsound.

Figure 1

Revised Unfunded Liability After Special Session
Based Upon Most Recent Actuarial Valuation ^a
Dollars in Millions

| Retirement System | Total Unfunded Liability | Amt Needed to Make Actuarially Sound | | |
|-------------------------------|-----------------------------|--------------------------------------|-----------------------|------------------|
| | | Before Session | Legislative Action | After Session |
| Public Employees | \$541.0 | \$266.2 | \$25.0 | \$241.2 |
| Game Wardens & Peace Officers | 5.5 | 1.2 | 0.0 | 1.2 |
| Sheriff | 10.9 | 15.1 | 0.0 | 15.1 |
| Teachers | <u>903.3</u> | <u>440.0</u> | <u>100.0</u> | <u>340.0</u> |
| Total | <u>\$1,460.7</u> | <u>\$722.5</u> | <u>\$125.0</u> | <u>\$597.5</u> |

^a The most recent actuarial valuation is as of June 30, 2005 for each of the retirement plans.

It should be emphasized that this figure reflects the unfunded liability as of June 30, 2005, based upon actuarial valuations prepared in late September, 2005. It should be understood that the numbers shown are based upon the actuarial assumptions applied to the analysis of each retirement plan and the asset values on June 30, 2005. The assumptions are of variables that can be volatile, the primary variable being investment returns. In addition, because these retirement plans still have existing unfunded liabilities that cannot be amortized in the required 30-year period, it is likely that the amount of unfunded liability that needs to be addressed will continue to grow. This of course will depend on the performance of the plans relative to the assumptions used in the valuations. Investment returns in excess of the assumptions would help mitigate growth in the unfunded liability. The status of these funds, as of June 30, 2006, will be reevaluated in the fall of 2006, preceding the 2007 regular session.

**LFD
COMMENT**

The fact that unfunded liabilities continue to exist in excess of the level that can be amortized in the 30-year period means that there is still work for the legislature to do. In the next session, the legislature will need to consider additional actions to solve the problem facing these four systems. Those actions could include another cash infusion (if additional moneys are available or if a bonding approach is considered), an increase in the employer contribution rates, or reform of the retirement plans for new hires. However, reforming the plans for new hires will not reduce the unfunded liabilities or actuarially fund the retirement plans and could end up increasing retirement costs in the short term. A list of options is provided below.

OPTIONS FOR LONG-TERM RESOLUTION OF UNFUNDED LIABILITY

The National Conference on State Legislatures (NCSL) prepared a report titled "Pension and Retirement Plan Enactments in 2005 State Legislatures". From this report, several different actions taken by various states have been identified, which the Montana legislature might consider. These actions are intended to either increase the money going into the system to pay down the unfunded liability or reduce the unfunded liability by lowering the cost of benefits paid in the future. Potential actions include:

- Appropriate funds directly to the retirement systems to reduce the unfunded liability. This is the same as was done in the special session when \$125 million general fund was appropriated to PERS and TRS. If this is considered, the legislature might want to examine the possibility of accessing other fund sources such as state special or proprietary funds in some instances.
- Shift from a defined benefit plan to a defined contribution plan for new hires. An action to replace the defined benefits plan with the defined contribution plan for all new hires would not change the unfunded liability that exists. It does, however, remove from the defined benefit plan those new members that would be contributing to reducing the unfunded liability. It has the effect of increasing the "normal costs" of paying benefits because without new employees to replace the retiring employees, fewer and fewer active employees are contributing to the system. Therefore, actuarial assumptions would have to change, resulting in a need for another revenue source, most likely employer contribution increases.
- Modify retirement eligibility and benefit calculations for new hires, such as increasing age and service requirements, or reducing the multiplier applied in the calculation to arrive at the benefit level. Currently, for PERS as an example, the multiplier is 1.78571 percent of [average annual salary times years of service] for persons retiring with up to 25 years of service. Persons retiring with 25 years or more have a multiplier of 2 percent. According to David Senn of TRS, "creating a new tier of benefits and contribution levels for employees hired in 2007 and beyond would effectively create a healthy new plan to support the current plan. At some point, the legislature is also going to be faced with proposals to increase the benefits in the new tier to match what other employees are receiving, which if adopted, would increase unfunded liabilities".
- Increase the number of years used for the final average salary calculation for new hires. Currently, PERS uses a 3-year average of 3 highest consecutive annual salaries. Some states have changed their calculation to use 5 years or 7 years. This has the effect of leveling out the salaries and mitigates a "spike in salary" that can result in higher, but unfunded, benefit increases.
- Limit the percent increase in salary allowed for the benefit calculation for new hires. Again, this would mitigate "spikes" in salaries.
- Increase the employee contribution for new hires.
- Increase the employer contribution for all active members. Because contributions are a product of payroll, which is funded by various sources, this option spreads the costs among the various fund sources (general fund, state special revenue, federal funds, and proprietary funds). This is part of the solution suggested in draft legislation by the SAVA committee.
- Avoid early retirement incentives.
- For early retirement incentives, have the employer pay the resulting unfunded liability.
- Have retirement system members and/or employers contribute an additional percentage toward an early retirement plan (refundable if not used).

- Close loopholes, such as salary spiking and creative return to work provisions. The Teachers' Retirement System has proposed some of these types of changes in the SAVA bill draft.
- Issue general obligation bonds using proceeds to pay down the liability for one or more of the four retirement systems. In preliminary estimates, when compared to the alternative of increasing employer contribution rates, it appears significantly less costly (in total funds) to pay the debt service than to pay the increased payroll costs over a thirty-year period. Other questions that should be considered are how the debt service payments would be funded (can all fund sources be accessed for debt service), and how would issuing this much debt affect Montana bond ratings and interest rates. There is an element of risk in this option. If the market under-performs what the state is paying on the bonds, the state could end up in a worse position than if the bonds were never issued, even though the retirement systems would be in better shape.

Some states have made changes to reduce benefits or increase employee contributions, but Legislative Services Division legal staff has indicated on different occasions that the Montana legislature does not have this option, based upon a constitutional argument concerning the existence of an employment contract which the legislature cannot alter by passing a law (see Article II, Section 31 of the Montana Constitution).



GENERAL FUND SUMMARY

INTRODUCTION

The general fund is the primary account that funds a majority of the general operations of state government. General fund expenditures represent about 37.5 percent of all state expenditures in the general, state special, federal special, and selected proprietary fund types authorized in HB 2 (general appropriations) and HB 447 (pay plan). Total revenues to the account for the 2007 biennium are estimated to be slightly less than \$3.140 billion, which is an increase of \$227.2 million (7.8 percent) from the 2005 biennium. Included in this increase are the impacts of SB 407 (individual income tax reduction) adopted by the 58th Legislature and all other tax policy/revenue legislation enacted by the 59th Legislature. There were a total of 57 bills approved during the regular session that impacted general fund revenue for the fiscal period 2005 through 2007. Total impact of this legislation is estimated to reduce revenues \$32.8 million over the 3-year period. No new revenue legislation was enacted during the December special legislative session.

Total disbursements (including legislative action) from the account for the 2007 biennium are estimated to be \$3.196 billion, which is an increase of \$560.4 million (21.3 percent) from the 2005 biennium. This amount is skewed by the \$125.0 million pension fund transfers authorized during the December special legislative session. There were a total of 34 bills approved during the regular session that impacted general fund disbursements for the fiscal period 2005 through 2007. There were four bills approved during the December special legislative session that impacted general fund disbursements for the 2007 biennium.

Balancing general fund appropriations against anticipated revenues is a major challenge of each legislature and requires significant coordination between the taxation and appropriation committees. Based on special session legislative revenue estimates, there are sufficient revenues to support the total general fund budget for the 2007 biennium, leaving an ending fund balance of \$228.6 million. This projected balance includes anticipated supplemental appropriations of \$38.3 million for the 2007 biennium.

This section provides a summary of the general fund account as projected through the 2007 biennium. It begins with a reconciliation of the current (2005 biennium) projected fund balance in order to arrive at the beginning balance for the 2007 biennium. It is followed by a summary of the 2007 biennium projected general fund balance using legislative revenue estimates and appropriations. An overview of actions by the December special legislative session is included.

2005 BIENNIUM ENDING FUND BALANCE

After completion of the regular legislative session (April 2005), the general fund balance was projected to be \$162.4 million. This balance was based on: 1) revenue estimates adopted in HJR 2; 2) LFD statutory appropriation, transfer, and reversion estimates; and 3) all general fund appropriations authorized by the legislature.

As shown in Figure 1, the revised general fund balance at the end of the 2005 biennium is projected to be \$297.4 million. The revised projection for the 2005 biennium general fund balance is based on preliminary FY 2005 information provided by the statewide accounting system (SABHRS). This projected balance equals 10.2 percent of anticipated revenues for the 2005 biennium and is \$135.0 million above the balance anticipated by the 59th Legislature.

Figure 1

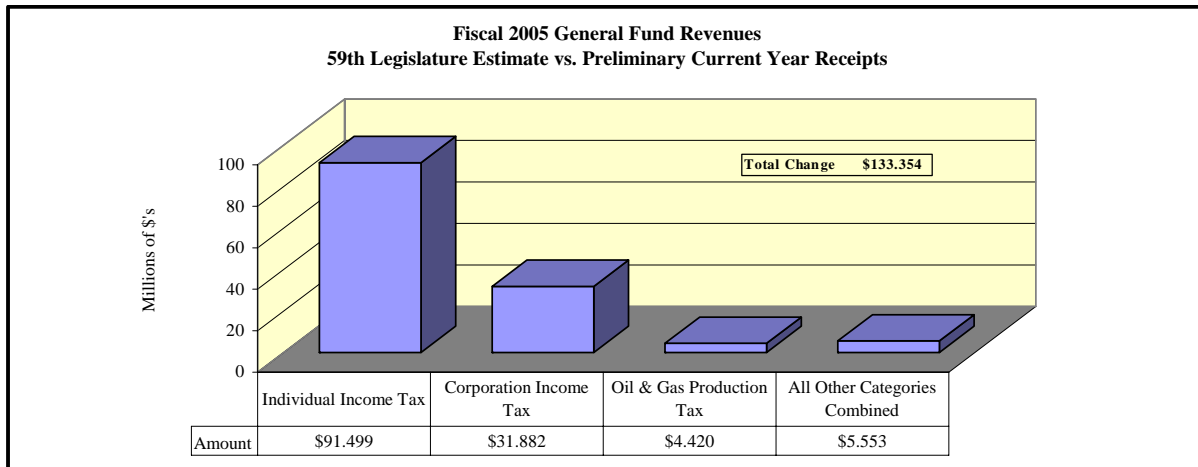
| Comparison of 2005 Biennium General Fund Balance Post Session Fiscal Report vs. Current LFD Analysis (In Millions) | | | |
|---|--------------------------------|-------------------------------|-----------------------------|
| | Fiscal Report 2005 Biennium | LFD Analysis 2005 Biennium | Difference 2005 Biennium |
| Beginning Fund Balance | \$43.065 | \$43.065 | \$0.000 |
| Revenues | | | |
| Current Law Revenue | <u>2,779.161</u> | <u>2,912.514</u> | <u>133.353</u> |
| Total Funds Available | \$2,822.226 | \$2,955.579 | \$133.353 |
| Disbursements | | | |
| General Appropriations | 2,374.634 | 2,361.312 | (13.322) |
| Statutory Appropriations | 255.260 | 255.189 | (0.071) |
| Non-Budgeted Transfers | <u>22.465</u> | <u>19.564</u> | <u>(2.901)</u> |
| Total Disbursements | \$2,652.359 | \$2,636.065 | (\$16.294) |
| Adjustments | (7.429) | (22.074) | (14.645) |
| Projected Ending Fund Balance | \$162.438 | \$297.440 | \$135.002 |

The increase in the projected general fund balance is due to several factors that have transpired since the adjournment of the 59th Legislature. Total general fund revenues (revenues plus legislation impacts) are expected to be \$133.4 million more than anticipated, while disbursements are expected to be \$16.3 million less than authorized by the 59th Legislature. Fund balance adjustments are expected to be \$14.6 million more than anticipated by the 59th Legislature.

The improved revenue condition (\$133.4 million) can be attributed to the factors shown in Figure 2. As shown in the figure, the three income sources primarily responsible for Montana's revenue picture reversal are individual income, corporation income, and oil and natural gas production taxes. Individual income tax has experienced increased growth resulting from higher net capital gains, dividend, and royalty incomes in calendar 2004. The corporation income tax has rebounded as Montana and multi-state corporations have recovered from the 2001 recession and the effects of "9/11". Additionally, the impact of the federal stimulus bonus depreciation provisions of calendar 2002 and 2003 will now create a decrease in the amount of depreciation expense corporations can claim in future years. This will result in increased tax liabilities. Finally, both oil and natural gas prices have increased dramatically in

response to the war in Iraq and uncertainty about future supplies. As a result of the higher prices, new drilling activity for oil and gas is up substantially. Production levels are once again increasing, reversing the production declines observed during the last ten years.

Figure 2



The primary reasons for the change in disbursements (\$16.3 million) and fund balance adjustments (\$14.6 million) are as follows:

Disbursements

For the 2005 biennium, disbursements were \$16.3 million less than anticipated. This difference is due to:

1. agency reversions being \$13.3 million more than the budgeted amount of \$6.9 million. Some of the agencies with significant reversions were: Legislative Branch (\$4.2 million), Office of Public Instruction (\$8.5 million), Department of Revenue (\$3.8 million), and Department of Public Health and Human Services (\$2.0 million); and
2. transfers being \$2.9 million below estimates, mostly from transfers not occurring as anticipated from the enactment of SB 87 and HB 170 in the 2005 legislative session.

Fund Balance Adjustments

Fund balance adjustments decrease \$14.6 million (to a negative \$22.1 million) from the budgeted amount of a negative \$7.4 million. The decrease is largely due to a negative \$2.1 million in adjustments to FY 2004 revenue accruals and \$10.9 million in adjustments to FY 2004 expenditure accruals. Of the expenditure adjustments, about \$9.1 million was due to wildfire costs (\$5.6 million) and US mineral royalty transfers (\$3.5 million). Although \$2.3 million of positive miscellaneous adjustments were anticipated, actual adjustments were only \$0.7 million or \$1.6 million less.

As Figure 1 shows, the combined impact of higher revenues, reduced disbursements, and higher fund balance adjustments is a net increase in the projected fund balance of \$135.0 million for the 2005 biennium.

2007 BIENNIUM PROJECTION

Figure 3 shows the 2007 biennium projected balance in the general fund account before and after action by the December special legislative session. The purpose of this comparison is to highlight legislative action that established the revised 2007 biennium budget. The pre-legislative action estimate of a positive \$425.4 million general fund balance was based on: 1) revenue estimates as contained in HJ 1 (special session revenue estimate resolution), 2) all appropriations as adopted by the 59th Legislature, and 3) LFD estimates for statutory appropriations, transfers, supplemental appropriations, and reversions.

In essence, the projected balance of \$425.4 million would be the balance if the special session legislature had not adopted any legislation during the December special legislative session.

The second estimate of \$228.6 million is the post-session estimate that incorporates all legislation enacted by the 59th Legislature and the December special legislative session. Figure 3 shows total legislative action (\$196.8 million) adopted by the special session legislature. The following discussion briefly explains their actions.

REVENUE ACTIONS

The December special legislative session supported the general fund revenue estimates as adopted by the Revenue and Transportation Committee (RTIC) on December 13, 2005. The RTIC increased the 2007 biennium revenue estimates by \$253.0 for the two-year period. A majority of these adjustments was for individual income, corporation income, and oil and natural gas production taxes. The "Revenue Summary" section of this report shows the revenue estimate adjustments as adopted by the RTIC.

A more detailed summary of general fund revenue estimates as included in HJ 1 (revenue estimate resolution) is provided in Appendix B. The December special legislative session did not enact legislation that impacted general fund anticipated revenues.

DISBURSEMENT ACTIONS

As shown in Figure 4 the December special legislative session increased general fund disbursements by \$196.8 million. This increase was for changes in public school funding (\$71.7 million), retirement system transfers (\$125.0 million), special session costs (\$65,000), and an expansion in the duties of the state administration and veterans' affairs interim committee (\$5,000).

Figure 3

| 2007 Biennium General Fund Balance In Millions | |
|--|-----------------------|
| Beginning Fund Balance | \$297.4 |
| Revenues | <u>3,139.7</u> |
| Available Funds | \$3,437.1 |
| Disbursements | |
| General Appropriations | 2,640.5 |
| Statutory Appropriations | 269.3 |
| Transfers | 54.4 |
| Miscellaneous Appropriations | 5.4 |
| Supplementals | 38.3 |
| Session Costs | 10.2 |
| Reversions | <u>(18.4)</u> |
| Totals Disbursements | 2,999.7 |
| Adjustments | (12.0) |
| Ending Fund Balance Before Legislative Action | \$425.4 |
| Legislative Action | |
| On-Going for Quality Schools | 37.217 |
| One-Time for Quality Schools | 34.500 |
| Retirement Systems Infusion | 125.000 |
| Expand Duties of Interim Committee | 0.005 |
| Special Session Feed Bill | <u>0.065</u> |
| Total Legislative Action | \$196.8 |
| Ending Fund Balance With Legislative Action | \$228.6 |

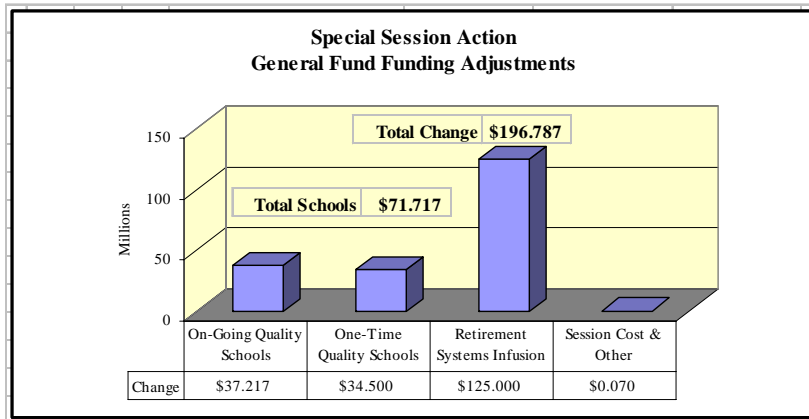


Figure 4

The largest dollar increase was for the cash infusion to the PERS and TRS pension trusts. For specifics on this issue, see the “Retirement Systems Unfunded Liability” section of this report. The legislature also adopted additional funding for public schools of \$71.7 million. Of this amount, \$34.5 million was for one-time only funding and \$37.3 million was for on-going funding. For specifics on this issue, see the “Public Schools Funding Action” section of this report. The special

session legislature also appropriated \$65,000 for session costs and \$5,000 for the state administration and veterans' affairs interim committee.

SUPPLEMENTAL APPROPRIATIONS

Figure 5 shows anticipated supplemental appropriations for the 2007 biennium. These amounts, as estimated by LFD staff, are included in the projected ending fund balance.

Department of Public Health and Human Services (DPHHS)

DPHHS has three areas of current and/or potential cost overruns:

1. A change in the percentage of Medicaid benefit costs paid by the federal government from the level assumed by the 2005 Legislature due to an improvement in Montana's relative personal income compared to the rest of the country;
2. Cost overruns at the Montana Development Center due to the impact of vacancy savings and higher than anticipated provider rate increases;
3. Higher than anticipated population at the Montana State Hospital.

Costs could be as high as over \$16 million or as low as under \$6 million, depending upon cost mitigation opportunities. The \$11.0 million estimate assumes the department will mitigate a portion of the cost overruns.

Department of Corrections

The Department of Corrections is currently experiencing higher population growth than assumed in the 2005 legislative session, exacerbated by increased utility, medical, extradition, Information Technology, contracts, and legal costs; and raises provided to department personnel. The current overrun is estimated at \$13.6 million. This total would be offset by other funds within the department and from the personal services contingency account to a currently estimated total of \$11.8 million. Because of limited other mitigation opportunities and the on-going nature of the population increases, Figure 5 assumes a continuing problem in FY 2007 for a total of \$22 million over the biennium.

Figure 5

| Supplemental Appropriations FY 2007 (In Millions) | |
|--|---------------|
| Agency | Amount |
| DPHHS | \$11.0 |
| Corrections | 22.0 |
| Revenue | <u>0.4</u> |
| Sub Total | \$33.4 |
| Wildfire Cost | 4.9 |
| Total | <u>\$38.3</u> |

Department of Revenue

The Department of Revenue has identified a cost overrun for implementation of the Property Assessment Division computer system due to an initial error in cost calculations. The department will mitigate some of the costs, leaving a shortfall of \$430,000.

Wildfire Cost

The Department of Natural Resources has incurred wildfire costs for the 2005 fire season of \$4.9 million. An estimate for the 2006 fire season has not been included in the estimated supplemental appropriation amounts.

FUND BALANCE PROJECTION

In summary, using the revenue estimates included in HJ 1 but without any additional funding authorized by the December special legislative session, the general fund ending fund balance for the 2007 biennium would be \$425.4 million. When actions by the December special legislative session are included, an ending balance in the general fund of \$228.6 million is projected. This balance is \$148.6 million above the targeted ending fund reserve of \$80 million.

Figure 6 shows the detailed general fund balance sheet. The 2007 biennium ending general fund balance is projected to be \$228.6 million, including all initiatives adopted by the regular and December special legislative sessions.

Figure 6

| 2007 Biennium General Fund Balance Action By the 59th Legislature With Preliminary Fiscal 2005 and Special Session Action In Millions | | | | | | |
|---|-----------------------|----------------------------|--------------------------|--------------------------|------------------------------|----------------------------|
| | Actual Fiscal 2004 | Preliminary Fiscal 2005 | Estimated Fiscal 2006 | Estimated Fiscal 2007 | Preliminary 2005 Biennium | Estimated 2007 Biennium |
| Beginning Fund Balance | \$43.065 | \$132.873 | \$297.440 | \$227.791 | \$43.065 | \$297.440 |
| Revenues | | | | | | |
| Current Law Revenue | 1,381.565 | 1,530.949 | 1,542.615 | 1,597.055 | 2,912.514 | 3,139.670 |
| Legislation Impacts | 0.000 | 0.000 | | | 0.000 | 0.000 |
| Residual Transfers | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| Total Revenue | \$1,381.565 | \$1,530.949 | \$1,542.615 | \$1,597.055 | \$2,912.514 | \$3,139.670 |
| Total Funds Available | \$1,424.630 | \$1,663.822 | \$1,840.055 | \$1,824.846 | \$2,955.579 | \$3,437.110 |
| Disbursements | | | | | | |
| General Appropriations | 1,165.925 | 1,234.274 | 1,311.367 | 1,329.097 | 2,400.199 | 2,640.464 |
| Statutory Appropriations | 126.600 | 128.589 | 134.343 | 134.978 | 255.189 | 269.321 |
| Local Assistance Appropriations | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| Miscellaneous Appropriations | 1.866 | 4.469 | 131.026 | 65.751 | 6.335 | 196.777 |
| Non-Budgeted Transfers | 10.052 | 9.512 | 24.926 | 29.509 | 19.564 | 54.435 |
| Continuing Appropriations | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| Supplemental Appropriations | 0.000 | 0.000 | 0.000 | 33.450 | 0.000 | 33.450 |
| Language Appropriations | 1.372 | 0.350 | 1.700 | 0.000 | 1.722 | 1.700 |
| Wildfire Costs | 0.000 | 0.000 | 4.876 | 0.000 | 0.000 | 4.876 |
| Feed Bill Appropriations | 0.000 | 0.000 | 2.186 | 8.050 | 0.000 | 10.236 |
| Carryforward Appropriations | 0.000 | 0.000 | 0.336 | 0.000 | 0.000 | 0.336 |
| Anticipated Reversions | (23.777) | (23.167) | (10.511) | (4.585) | (46.944) | (15.096) |
| Total Disbursements | \$1,282.038 | \$1,354.027 | \$1,600.249 | \$1,596.250 | \$2,636.065 | \$3,196.499 |
| Adjustments | (9.719) | (12.355) | (12.015) | 0.000 | (22.074) | (12.015) |
| Unreserved Ending Fund Balance | \$132.873 | \$297.440 | \$227.791 | \$228.596 | \$297.440 | \$228.596 |
| Special Session Legislative Action | | | | | | |
| On-Going for Quality Schools | | | | 37.217 | | 37.217 |
| One-Time for Quality Schools | | | 4.500 | 30.000 | | 34.500 |
| Retirement Systems Infusion | | | 125.000 | | | 125.000 |
| Expand Duties of Interim Committee | | | 0.005 | | | 0.005 |
| Special Session Feed Bill | | | 0.065 | | | 0.065 |
| Total Legislative Action | | | \$129.570 | \$67.217 | | \$196.787 |
| Unreserved Ending Fund Balance With Proposals | | | | | | |

2009 BIENNIUM OUTLOOK

Figure 7 shows the projected general fund balance for the 2009 biennium. Amounts shown include the revenue estimates as developed by the LFD staff and the cost of operating state government based on present law requirements. Present law is statutorily defined as the additional level of funding needed to maintain operations and services at the level authorized by the previous legislature. These disbursement amounts are as estimated by the LFD staff. The present law amounts shown for both anticipated revenues and expenditures do not include any proposals or initiatives recommended by the executive.

As Figure 7 shows, the 2009 biennium ending general fund balance is projected to be a positive \$375.4 million before any new proposals or initiatives are considered. This balance indicates the state can maintain the existing present level of services without a reduction in services or revenue enhancements. When action by the December special session legislature for public school funding is included (on-going costs of \$37.2 million per year), the projected ending fund balance in the general fund is \$301.0 million, well above a targeted reserve of \$80 million.

However, a positive ending fund balance does not necessarily indicate structural balance or revenue sustainability. Structural balance is simply the balance of on-going revenues with on-going disbursements. If on-going revenues equal or exceed on-going disbursements, then structural balance is achieved. Conversely, if on-going expenditures exceed on-going revenues, then structural imbalance occurs.

As shown in Figure 7, the structural balance for the 2009 biennium is projected to be \$72.4 million after funding the on-going costs for public schools adopted during the December special legislative session. This means there would be \$72.4 million or \$36.2 million per year of on-going revenue to fund any other on-going proposals or initiatives.

The following is a list of potential funding needs in addition to public school funding not included in the above present law forecast. The executive and the 2007 Legislature may need to consider these issues in determining funding priorities for the 2009 biennium.

- 2009 biennium negotiated state employee pay plan
- Pension funds unfunded liability permanent solution (e.g., employer rate increase, bonding, reduced benefit)
- Changes in FMAP (federal Medicaid match rate) due to change in state per capita income
- Human Services caseload/cost increases above projections
- Medicare Part D (prescription drug) federal cost recovery due to state savings ("clawback")

Figure 7

| 2009 Biennium General Fund Balance In Millions | |
|---|-----------------------|
| Beginning Fund Balance | \$228.6 |
| Revenues | <u>3,293.4</u> |
| Available Funds | \$3,522.0 |
| Disbursements | |
| Present Law Costs | 2,821.5 |
| Statutory Appropriations | 295.2 |
| Transfers | 19.9 |
| Session Costs | <u>10.0</u> |
| Totals Disbursements | 3,146.6 |
| Ending Fund Balance | \$375.4 |
| Legislative Action (Public Schools) | 74.4 |
| Ending Fund Balance With Proposals | \$301.0 |
| Structural Balance Condition | |
| Revenues | 3,293.4 |
| Disbursements | <u>3,221.0</u> |
| Structural Balance | \$72.4 |

- Potential federal deficit reduction cutbacks in human services and other state programs (to the extent the legislature chooses to replace the cutbacks with state funds)
- State Fund “old fund” shortfall (current estimate is \$14 million)
- Long Range Building Program deferred maintenance backlog on state buildings
- 2007 Biennium supplemental appropriations (on average, \$30 million per biennium)
- Other new initiatives (new proposals historically have been \$25 to \$75 million per biennium, excluding pay plan)

There are also volatile areas in the revenue estimates that could result in significant swings in revenues, either up or down. These include:

- A significant change in capital gains income - what level will be sustained over the long term?
- Oil and gas production/price levels – what level will be sustained over the long term?
- Calendar 2005 tax reform (rate reductions) – increased refund activity in FY 2006?
- A significant change in corporate profits – what level will be sustained over the long term?

REVENUE SUMMARY

GENERAL FUND REVENUE ESTIMATES

This section provides a summary of the general fund revenue estimates for the 2007 biennium. These estimates are as shown in HJ 1, the revenue estimate resolution. It should be noted that these estimates include the revenue impacts of all legislation enacted during the regular legislative session. The December special legislative session did not enact any legislation that impacted anticipated general fund revenues.

HOUSE JOINT RESOLUTION 1

On December 13, 2005, prior to the convening of the special session Legislature, the Revenue and Transportation Interim Committee (RTIC) formally adopted general fund revenue estimates for fiscal 2006 and 2007. This process was in accordance with 5-18-107, MCA, which states that these estimates “constitute the legislature’s current revenue estimates until amended or until final adoption of the estimates by both houses.” The actions taken by the RTIC were incorporated into HJ 1 and were introduced at the beginning of the special session Legislature. During the legislative process, the House Appropriations committee held one hearing on HJ 1 and did not adopt any amendments. While in executive action on the resolution, the motion “do pass” tied on a ten/ten vote. Since legislative rules required legislation with tied committee votes to be transmitted to the appropriate chamber, the resolution was forwarded to the House floor. The House did not take action on the resolution.

Figure 8 shows the current law general fund revenue estimates as contained in HJ 1 for the 2007 biennium. Also shown in the figure is the revenue source, the revenue estimate as adopted by the regular legislative session, and the difference between the two estimates. As indicated in the figure, total general fund revenue estimates for the 2007 biennium were increased by \$253.0 million. The only sources with adjustments were individual income tax (\$153.2 million), property tax (\$5.4 million), corporation income tax (\$65.8 million), and oil and gas production tax (\$28.6 million). A more detailed summary of general fund revenue estimates is provided in Appendix B. Appendix C shows HJ 1 as transmitted to the House floor.

Figure 8

| General Fund Revenue Estimates In Millions | | | | | | | | | | | |
|---|---------------------|--------------------------|-------------------|-----------|--------------------------|-------------------|-----------|--------------------------|-------------------|-----------|--------------------------|
| Source of Revenue | Percent Biennium | Fiscal 2006 | | | Fiscal 2007 | | | 2006-2007 Biennium | | | Cumulative % of Total |
| | | HJ 2 Plus Legislation | HJ1 Resolution | Change | HJ 2 Plus Legislation | HJ1 Resolution | Change | HJ 2 Plus Legislation | HJ1 Resolution | Change | |
| 1 Individual Income Tax | 44.29% | 607.178 | 677.815 | 70.637 | 630.060 | 712.611 | 82.551 | 1,237.238 | 1,390.426 | 153.188 | 44.29% |
| 2 Property Tax | 11.44% | 173.804 | 176.391 | 2.587 | 180.062 | 182.900 | 2.838 | 353.866 | 359.291 | 5.425 | 55.73% |
| 3 Oil & Natural Gas Production Tax | 6.11% | 61.192 | 99.410 | 38.218 | 64.958 | 92.554 | 27.596 | 126.150 | 191.964 | 65.814 | 61.84% |
| 4 Corporation Income Tax | 6.01% | 81.148 | 91.427 | 10.279 | 78.997 | 97.281 | 18.284 | 160.145 | 188.708 | 28.563 | 67.85% |
| 5 Vehicle Tax | 5.17% | 80.140 | 80.140 | - | 82.050 | 82.050 | - | 162.190 | 162.190 | - | 73.02% |
| 6 Insurance Tax & License Fees | 4.02% | 61.580 | 61.580 | - | 64.637 | 64.637 | - | 126.217 | 126.217 | - | 77.04% |
| 7 Video Gambling Tax | 3.58% | 55.031 | 55.031 | - | 57.509 | 57.509 | - | 112.540 | 112.540 | - | 80.62% |
| 8 Motor Vehicle Fee | 2.29% | 35.029 | 35.029 | - | 36.960 | 36.960 | - | 71.989 | 71.989 | - | 82.92% |
| 9 Cigarette Tax | 2.07% | 33.069 | 33.069 | - | 31.790 | 31.790 | - | 64.859 | 64.859 | - | 84.98% |
| 10 Coal Trust Interest | 2.05% | 32.211 | 32.211 | - | 32.290 | 32.290 | - | 64.501 | 64.501 | - | 87.04% |
| 11 All Other Revenue | 1.82% | 27.389 | 27.389 | - | 29.601 | 29.601 | - | 56.990 | 56.990 | - | 88.85% |
| 12 US Mineral Royalty | 1.74% | 26.712 | 26.712 | - | 27.962 | 27.962 | - | 54.674 | 54.674 | - | 90.59% |
| 13 Telecommunications Excise Tax | 1.40% | 21.700 | 21.700 | - | 22.101 | 22.101 | - | 43.801 | 43.801 | - | 91.99% |
| 14 Public Institution Reimbursements | 0.96% | 15.127 | 15.127 | - | 15.049 | 15.049 | - | 30.176 | 30.176 | - | 92.95% |
| 15 Treasury Cash Account Interest | 0.87% | 13.102 | 13.102 | - | 14.367 | 14.367 | - | 27.469 | 27.469 | - | 93.82% |
| 16 Liquor Excise & License Tax | 0.75% | 11.535 | 11.535 | - | 11.959 | 11.959 | - | 23.494 | 23.494 | - | 94.57% |
| 17 Lodging Facility Use Tax | 0.70% | 10.715 | 10.715 | - | 11.419 | 11.419 | - | 22.134 | 22.134 | - | 95.28% |
| 18 Coal Severance Tax | 0.54% | 8.466 | 8.466 | - | 8.644 | 8.644 | - | 17.110 | 17.110 | - | 95.82% |
| 19 Lottery Profits | 0.50% | 7.844 | 7.844 | - | 7.839 | 7.839 | - | 15.683 | 15.683 | - | 96.32% |
| 20 Liquor Profits | 0.44% | 6.786 | 6.786 | - | 7.017 | 7.017 | - | 13.803 | 13.803 | - | 96.76% |
| 21 Nursing Facilities Fee | 0.37% | 5.851 | 5.851 | - | 5.824 | 5.824 | - | 11.675 | 11.675 | - | 97.13% |
| 22 Metalliferous Mines Tax | 0.34% | 5.236 | 5.236 | - | 5.438 | 5.438 | - | 10.674 | 10.674 | - | 97.47% |
| 23 Highway Patrol Fines | 0.33% | 5.042 | 5.042 | - | 5.324 | 5.324 | - | 10.366 | 10.366 | - | 97.80% |
| 24 Investment License Fee | 0.30% | 4.598 | 4.598 | - | 4.736 | 4.736 | - | 9.334 | 9.334 | - | 98.10% |
| 25 Electrical Energy Tax | 0.27% | 4.276 | 4.276 | - | 4.270 | 4.270 | - | 8.546 | 8.546 | - | 98.37% |
| 26 Tobacco Tax | 0.24% | 3.779 | 3.779 | - | 3.847 | 3.847 | - | 7.626 | 7.626 | - | 98.62% |
| 27 Wholesale Energy Tax | 0.23% | 3.520 | 3.520 | - | 3.555 | 3.555 | - | 7.075 | 7.075 | - | 98.84% |
| 28 Beer Tax | 0.19% | 2.986 | 2.986 | - | 3.039 | 3.039 | - | 6.025 | 6.025 | - | 99.03% |
| 29 Driver's License Fee | 0.18% | 2.784 | 2.784 | - | 2.792 | 2.792 | - | 5.576 | 5.576 | - | 99.21% |
| 30 Public Contractors Tax | 0.18% | 3.030 | 3.030 | - | 2.522 | 2.522 | - | 5.552 | 5.552 | - | 99.39% |
| 31 Rental Car Sales Tax | 0.18% | 2.704 | 2.704 | - | 2.820 | 2.820 | - | 5.524 | 5.524 | - | 99.56% |
| 32 Tobacco Settlement | 0.15% | 2.319 | 2.319 | - | 2.309 | 2.309 | - | 4.628 | 4.628 | - | 99.71% |
| 33 Railroad Car Tax | 0.10% | 1.574 | 1.574 | - | 1.562 | 1.562 | - | 3.136 | 3.136 | - | 99.81% |
| 34 Wine Tax | 0.10% | 1.487 | 1.487 | - | 1.538 | 1.538 | - | 3.025 | 3.025 | - | 99.91% |
| 35 Estate Tax | 0.09% | 1.950 | 1.950 | - | 0.939 | 0.939 | - | 2.889 | 2.889 | - | 100.00% |
| Total General Fund | 100.00% | \$1,420.894 | \$1,542.615 | \$121.721 | \$1,465.786 | \$1,597.055 | \$131.269 | \$2,886.680 | \$3,139.670 | \$252.990 | 100.00% |
| Common School Interest & Income | | \$57.149 | \$67.013 | \$9.864 | \$56.233 | \$64.225 | \$7.992 | \$113.382 | \$131.238 | \$17.856 | |



INDEX TO OTHER LFD BUDGET REFERENCE DOCUMENTS

In addition to this volume, there are several other LFD documents that legislators and other interested parties can use as a source of information concerning budget and other fiscal matters. A limited number of reports of past biennia are available for reference in the LFD office (photo copies of pages of interest can be made). Training publications and brochures are available for distribution and on the LFD website. Check with an LFD staff member for assistance.

LFD BUDGET ANALYSIS AND FISCAL REPORT

The *Legislative Budget Analysis* is prepared prior to the beginning of each session and the *Legislative Fiscal Report* is published at the end of each session. The latter is a record of legislative actions that resulted from the enactment of House Bill 2 and other appropriation legislation, as well as revenue estimation and discussion of other fiscal issues. Both publications are available on-line at:

<http://leg.state.mt.us/css/fiscal/reports.asp>, and can be purchased through legislative printing.

Previous versions of the reports from 1979 onward are stored in the LFD office and the State Library. Reports from the 2000 Special Session onward are also available on-line at the above address.

SCHOOL FUNDING PRIMER

A primer on the school funding system prior to the 2005 special session can be found in Volume 1 of the 2005 regular session Legislative Fiscal Report, available for photocopying in the LFD office and online at:

http://leg.state.mt.us/content/publications/fiscal/fr_2007/vol_1/ref_index.pdf

SCHOOL FUNDING LEGISLATION IMPACT

A listing of the impact on individual school districts of the 2005 special session school legislation can be accessed through the Legislative Fiscal Division website at:

http://leg.state.mt.us/content/publications/fiscal/ss_2005/School_District_Impact.htm

TRAINING PUBLICATIONS

Training material prepared by the LFD include the following:

- *Understanding State Finances and the Budgeting Process* (A Reference Manual for Legislators) is a helpful guide for persons wanting more detailed information concerning fiscal matters
- *HB 2 the Barbarian* (How to Make HB 2 Implement Public Policy as Determined by the Legislature) describes the intricacies of developing the general appropriations act

Both publications are available in the LFD office and online at:

http://leg.state.mt.us/css/fiscal/reports.asp#leg_reference

FISCAL POCKET GUIDES

A variety of brochures have been prepared to provide summary information concerning select topics important to legislators and other interested parties. The pocket guides are available at the entrance to the LFD offices, in the legislative library, and online at:

http://leg.state.mt.us/css/fiscal/reports.asp#leg_reference

- Basic State Finances
- General Fund Fiscal 2002, 2003, 2004,2005
- State Employees
- Higher Education Funding
- Medicaid
- Montana Highway Funding
- Pertinent State Statistics
- Resource Indemnity Trust
- TANF (temporary assistance to needy families)
- Montana's Tobacco Settlement
- Montana's Budgeting Process
- Bed Tax
- Insurance Tax & License Fee
- Individual Income Tax
- Tobacco Tax
- Video Gambling Tax
- Cigarette Tax
- Wine Tax
- Liquor Excise Tax
- Beer Tax
- Corporation Income Tax
- Property Tax
- Coal Tax
- Coal Trusts

The LFD would welcome suggestions for other possible topics for pocket guides.

OFFICE OF THE GOVERNOR
STATE OF MONTANABRIAN SCHWEITZER
GOVERNORJOHN BOHLINGER
LT. GOVERNOR

TO: Members of the Montana Senate
Members of the House of Representatives
Secretary of State Brad Johnson
Members of the Montana Supreme Court c/o Clerk of the Court Ed Smith

STATE OF MONTANA
OFFICE OF THE GOVERNOR
PROCLAMATIONCALL TO THE 59TH LEGISLATURE
FOR A SPECIAL SESSION

WHEREAS, pursuant to Article V, section 6 of the Constitution of the State of Montana and § 5-3-101, MCA, the Governor may convene the legislature in special session; and

WHEREAS, pursuant to Article VI, section 11 of the Constitution of the State of Montana, the Governor may convene the legislature whenever he considers it in the public interest; and

WHEREAS, the Montana Supreme Court, in *Columbia Falls Elementary School District No. 6 v. State of Montana*, 2005 MT 69, held that Montana's system for funding its public elementary and secondary schools was unconstitutional in that the funding system was not based on a definition of a quality education and the requirement to recognize the cultural heritage of American Indians was not being fulfilled; and

WHEREAS, the 59th Legislature, through passage of Senate Bill No. 152 (SB 152), defined a "basic system of free quality public elementary and secondary schools," as required by Article X, section 1(3) of the Montana Constitution and the Montana Supreme Court's ruling; and

WHEREAS, the 59th Legislature, for the first time in Montana history, consistent with the Montana Constitution and the Montana Supreme Court's ruling, appropriated in excess of \$3.4 million for the 2006-07 biennium to fund education related to the preservation of the distinct and unique cultural heritage of American Indians; and

WHEREAS, the 59th Legislature increased funding for Montana's K-12 schools by appropriating more than \$88 million in new money for the biennium – an historic increase; and

WHEREAS, the 59th Legislature, through passage of Senate Bill No. 525 (SB 525), established a quality schools interim committee to devise, by December 1, 2005, a funding formula for Montana's public elementary and secondary schools based on the definition of quality education enacted by the 59th Legislature; and

WHEREAS, the quality schools interim committee has accomplished the tasks assigned to it under SB 525, but has not agreed upon any one school funding formula; and

WHEREAS, in addition to the constitutional requirement that the legislature provide a basic system of free quality public elementary and secondary schools, Article VIII, section 9 of the Constitution of the State of Montana requires the state to maintain a balanced budget by directing that legislative appropriations not exceed anticipated revenue; and

WHEREAS, one component of a quality education system is the ability to recruit and retain qualified teachers, and in order to be able to recruit and retain qualified teachers, schools must be able to offer teachers competitive benefit packages; and

WHEREAS, Montana's teachers' retirement system currently has an unfunded liability exceeding \$900,000,000.00; and

WHEREAS, Montana's public retirement system currently has an unfunded liability exceeding \$500,000,000.00; and

WHEREAS, school boards are beginning the process of preparing their budgets for the 2006-07 academic year; and

WHEREAS, the regular session of the 59th Legislature completed its work in eighty-six days anticipating the likelihood of a special legislative session to enact a school funding system based on the definition of a quality education; and

WHEREAS, it is in the public interest of all Montanans that the 59th Legislature convene in special session to consider these matters.

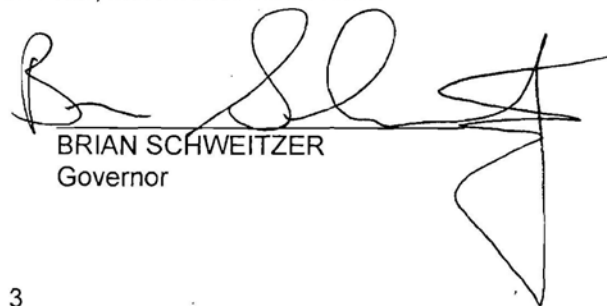
NOW, THEREFORE, I, BRIAN SCHWEITZER, GOVERNOR OF THE STATE OF MONTANA, pursuant to the authority vested in me by the Constitution and laws of the State of Montana, do hereby convene the Fifty-Ninth Legislature in special session, in Helena, at the Capitol, at the hour of 9:00 a.m., the 14th day of December, 2005, and hereby limit the special session to the following subjects:

1. Legislation to enact a funding system for Montana's public elementary and secondary schools that is based on the definition of a quality education contained in SB 152 and that recognizes the cultural heritage of American Indians, in compliance with Article X, section 1 of the Montana Constitution and in fulfillment of the requirements of

the Montana Supreme Court's decision in *Columbia Falls Elementary School v. State of Montana*, and that also remains within a balanced budget, as required by Article VIII, section 9 of the Montana Constitution;

2. An appropriation for the funding system enacted by the Legislature in special session in compliance with the Montana Constitution and the Supreme Court's holding;
3. An appropriation of one-time money from the general fund to Montana's public elementary and secondary schools for recognition of the cultural heritage of American Indians and to address the following needs of schools: facility studies, weatherization for long-term energy savings, deferred maintenance, and assistance with utility and transportation energy costs;
4. An appropriation of \$100 million from the general fund to the teachers' retirement system to both reduce the unfunded liability of the system and to help improve Montana's ability to recruit and retain qualified teachers;
5. An appropriation of \$25 million from the general fund to the public retirement system to help reduce the unfunded liability of the system;
6. LC 2006-2, approved by the State Administration and Veterans' Affairs Interim Committee on November 30, 2005;
7. An updated revenue estimate requested by the revenue and transportation committee;
8. Confirmation of the chief water judge and the workers' compensation judge, as required by § 3-1-1013, MCA;
9. Confirmation of the governor's vacancy appointment of the director of the department of public health and human services; and
10. Any appropriations necessary for the operation of the special legislative session.

IN WITNESS WHEREOF, I have hereunto set my hand and caused the Great Seal of the State of Montana to be affixed. DONE at the City of Helena, the Capitol, this 5th day of December, in the year of our Lord, two thousand and five.



BRIAN SCHWEITZER
Governor

REVENUE ESTIMATES

Introduction

As delineated in Section 5-18-107(1) (a), MCA, the Revenue and Transportation Interim Committee (RTIC) is required to prepare “an estimate of the amount of revenue projected to be available for legislative appropriation.” In addition, sections 5-12-302(2) and 5-12-307(7) specifically require the Legislative Fiscal Analyst (LFA) to “estimate revenue from existing and proposed taxes” and also requires the LFA to “assist the revenue and transportation committee in performing its revenue estimating duties...”.

The following sections address the actions of the RTIC on December 13, 2005 and the December special session legislature. It should be noted that the accompanying forecasts are based on current federal and state laws and do not include estimates for revenues due to litigation or any other pending legal issues. This position is consistent with past actions of the RTIC and the legislature.

Revenue and Transportation Interim Committee Action

At the September 30, 2005 meeting, the RTIC directed LFD staff to provide revised general fund revenue estimate recommendations to the committee in anticipation of a special legislative session. Since a majority of the difference between FY 2005 actual collections and HJ 2 revenue estimates (adjusted for legislation) was due to individual income and corporation income taxes, and to some degree, oil and natural gas production taxes, the committee directed staff to limit their review and potential adjustments to only the economic assumptions and the associated revenue estimates for these three sources. As had been done in the past, the committee also directed LFD staff to calculate the associated impact on US mineral royalty and common school interest and income revenues provided an adjustment was adopted for oil and natural gas price and production levels. The one exception to the above direction was for property tax. Because the committee felt taxable values of property classes were essential to the development of a new public school funding formula, it directed staff to review property tax taxable value assumptions. Even though the Quality Schools Interim Committee did not recommend school funding legislation for the special legislative session, staff provided updated property tax estimates based on known taxable values for tax year 2005 (FY 2006). All other revenue sources remained as contained in HJ 2 as amended by the 59th Legislature.

Based on LFD staff recommendations, Figure 1 shows the revised revenue estimates adopted by RTIC for FY 2006 and 2007 for the general fund account. Information provided includes the original HJ 2 plus legislation estimate, the revised estimate, and the difference for each year of the 2007 biennium. As shown in the figure, the committee recommended the general fund estimates be increased by \$121.7 million in FY 2006 and \$131.3 million in FY 2007 for a biennial adjustment of \$253.0 million.

Common school interest and income estimates, which are non-general fund revenues, were recommended to be adjusted by \$9.9 million in FY 2006 and \$8.0 million in FY 2007 for a biennial increase of \$17.9 million.

| General Fund Revenue Estimates In Millions | | | | | | | | | | | |
|---|---------------------|--------------------------|-------------------|-----------|--------------------------|-------------------|-----------|--------------------------|-------------------|-----------|--------------------------|
| Source of Revenue | Percent Biennium | Fiscal 2006 | | | Fiscal 2007 | | | 2006-2007 Biennium | | | Cumulative % of Total |
| | | HJ 2 Plus Legislation | HJ1 Resolution | Change | HJ 2 Plus Legislation | HJ1 Resolution | Change | HJ 2 Plus Legislation | HJ1 Resolution | Change | |
| 1 Individual Income Tax | 44.29% | 607.178 | 677.815 | 70.637 | 630.060 | 712.611 | 82.551 | 1,237.238 | 1,390.426 | 153.188 | 44.29% |
| 2 Property Tax | 11.44% | 173.804 | 176.391 | 2.587 | 180.062 | 182.900 | 2.838 | 353.866 | 359.291 | 5.425 | 55.73% |
| 3 Oil & Natural Gas Production Tax | 6.11% | 61.192 | 99.410 | 38.218 | 64.958 | 92.554 | 27.596 | 126.150 | 191.964 | 65.814 | 61.84% |
| 4 Corporation Income Tax | 6.01% | 81.148 | 91.427 | 10.279 | 78.997 | 97.281 | 18.284 | 160.145 | 188.708 | 28.563 | 67.85% |
| 5 Vehicle Tax | 5.17% | 80.140 | 80.140 | - | 82.050 | 82.050 | - | 162.190 | 162.190 | - | 73.02% |
| 6 Insurance Tax & License Fees | 4.02% | 61.580 | 61.580 | - | 64.637 | 64.637 | - | 126.217 | 126.217 | - | 77.04% |
| 7 Video Gambling Tax | 3.58% | 55.031 | 55.031 | - | 57.509 | 57.509 | - | 112.540 | 112.540 | - | 80.62% |
| 8 Motor Vehicle Fee | 2.29% | 35.029 | 35.029 | - | 36.960 | 36.960 | - | 71.989 | 71.989 | - | 82.92% |
| 9 Cigarette Tax | 2.07% | 33.069 | 33.069 | - | 31.790 | 31.790 | - | 64.859 | 64.859 | - | 84.98% |
| 10 Coal Trust Interest | 2.05% | 32.211 | 32.211 | - | 32.290 | 32.290 | - | 64.501 | 64.501 | - | 87.04% |
| 11 All Other Revenue | 1.82% | 27.389 | 27.389 | - | 29.601 | 29.601 | - | 56.990 | 56.990 | - | 88.85% |
| 12 US Mineral Royalty | 1.74% | 26.712 | 26.712 | - | 27.962 | 27.962 | - | 54.674 | 54.674 | - | 90.59% |
| 13 Telecommunications Excise Tax | 1.40% | 21.700 | 21.700 | - | 22.101 | 22.101 | - | 43.801 | 43.801 | - | 91.99% |
| 14 Public Institution Reimbursements | 0.96% | 15.127 | 15.127 | - | 15.049 | 15.049 | - | 30.176 | 30.176 | - | 92.95% |
| 15 Treasury Cash Account Interest | 0.87% | 13.102 | 13.102 | - | 14.367 | 14.367 | - | 27.469 | 27.469 | - | 93.82% |
| 16 Liquor Excise & License Tax | 0.75% | 11.535 | 11.535 | - | 11.959 | 11.959 | - | 23.494 | 23.494 | - | 94.57% |
| 17 Lodging Facility Use Tax | 0.70% | 10.715 | 10.715 | - | 11.419 | 11.419 | - | 22.134 | 22.134 | - | 95.28% |
| 18 Coal Severance Tax | 0.54% | 8.466 | 8.466 | - | 8.644 | 8.644 | - | 17.110 | 17.110 | - | 95.82% |
| 19 Lottery Profits | 0.50% | 7.844 | 7.844 | - | 7.839 | 7.839 | - | 15.683 | 15.683 | - | 96.32% |
| 20 Liquor Profits | 0.44% | 6.786 | 6.786 | - | 7.017 | 7.017 | - | 13.803 | 13.803 | - | 96.76% |
| 21 Nursing Facilities Fee | 0.37% | 5.851 | 5.851 | - | 5.824 | 5.824 | - | 11.675 | 11.675 | - | 97.13% |
| 22 Metalliferous Mines Tax | 0.34% | 5.236 | 5.236 | - | 5.438 | 5.438 | - | 10.674 | 10.674 | - | 97.47% |
| 23 Highway Patrol Fines | 0.33% | 5.042 | 5.042 | - | 5.324 | 5.324 | - | 10.366 | 10.366 | - | 97.80% |
| 24 Investment License Fee | 0.30% | 4.598 | 4.598 | - | 4.736 | 4.736 | - | 9.334 | 9.334 | - | 98.10% |
| 25 Electrical Energy Tax | 0.27% | 4.276 | 4.276 | - | 4.270 | 4.270 | - | 8.546 | 8.546 | - | 98.37% |
| 26 Tobacco Tax | 0.24% | 3.779 | 3.779 | - | 3.847 | 3.847 | - | 7.626 | 7.626 | - | 98.62% |
| 27 Wholesale Energy Tax | 0.23% | 3.520 | 3.520 | - | 3.555 | 3.555 | - | 7.075 | 7.075 | - | 98.84% |
| 28 Beer Tax | 0.19% | 2.986 | 2.986 | - | 3.039 | 3.039 | - | 6.025 | 6.025 | - | 99.03% |
| 29 Driver's License Fee | 0.18% | 2.784 | 2.784 | - | 2.792 | 2.792 | - | 5.576 | 5.576 | - | 99.21% |
| 30 Public Contractors Tax | 0.18% | 3.030 | 3.030 | - | 2.522 | 2.522 | - | 5.552 | 5.552 | - | 99.39% |
| 31 Rental Car Sales Tax | 0.18% | 2.704 | 2.704 | - | 2.820 | 2.820 | - | 5.524 | 5.524 | - | 99.56% |
| 32 Tobacco Settlement | 0.15% | 2.319 | 2.319 | - | 2.309 | 2.309 | - | 4.628 | 4.628 | - | 99.71% |
| 33 Railroad Car Tax | 0.10% | 1.574 | 1.574 | - | 1.562 | 1.562 | - | 3.136 | 3.136 | - | 99.81% |
| 34 Wine Tax | 0.10% | 1.487 | 1.487 | - | 1.538 | 1.538 | - | 3.025 | 3.025 | - | 99.91% |
| 35 Estate Tax | 0.09% | 1.950 | 1.950 | - | 0.939 | 0.939 | - | 2.889 | 2.889 | - | 100.00% |
| Total General Fund | 100.00% | \$1,420.894 | \$1,542.615 | \$121.721 | \$1,465.786 | \$1,597.055 | \$131.269 | \$2,886.680 | \$3,139.670 | \$252.990 | 100.00% |
| Common School Interest & Income | | \$57.149 | \$67.013 | \$9.864 | \$56.233 | \$64.225 | \$7.992 | \$113.382 | \$131.238 | \$17.856 | |

The actions taken by the RTIC were incorporated into HJ 1 (revenue estimate resolution) and were introduced at the beginning of the December special session Legislature. During the legislative process, the House Appropriations committee held one hearing on HJ 1 and did not adopt any amendments. While in executive action on the resolution, the motion “do pass” tied on a ten/ten vote. Since legislative rules required legislation with tied committee votes to be transmitted to the appropriate chamber, the resolution was forwarded to the House floor. The House did not take action on the resolution.

Since the legislature did not adjust the recommendations of the RTIC, Figure 1 reflects the current law general fund revenue estimates as contained in HJ 1 for the 2007 biennium. As indicated in Figure 1, total general fund revenue estimates for the 2007 biennium were increased by \$253.0 million. The only sources with adjustments were individual income tax (\$153.2 million), property tax (\$5.4 million), corporation income tax (\$65.8 million), and oil and gas production tax (\$28.6 million).

The following section of Appendix B provides detailed information on the five sources of revenue, corporation income tax, individual income tax, oil and natural gas production tax, property tax, and common school interest and income revenue.

REVENUE ESTIMATE DETAIL

The following section of this report contains revenue estimate recommendations by RTIC for five revenue sources:

1. Corporation Income Tax
2. Individual Income Tax
3. Oil and Natural Gas Production Tax
4. Property Tax
5. Common Schools Interest & Income

A profile for each of the above revenue sources contains 10 categories of information. These categories and a short description of each follow:

Revenue Description: A brief description of the source is provided including the origin of the revenue and, in the case of taxes and fees, the item that is taxed.

Applicable Tax Rate(s): This section provides an explanation of the tax rate or license fee, more detail on the items that are taxed, and other information such as exemptions, minimums, initial versus annual fees, etc.

Distribution: This section shows how the revenue is distributed. In cases where uses or entities other than general fund receive a portion of the revenue, percentage distribution or the dollar amount is shown for each recipient.

Collection Frequency: Timing of the revenue deposited in the state treasury may affect the revenue estimate. Most revenue is usually received on a quarterly or monthly basis.

Statutory Reference: These are the citations from the Montana Code Annotated (MCA) applicable to the revenue source and include citations for the tax rate, the distribution, and when the tax is due.

Additional Information Since Adjournment: A general description of changes that have impacted the specific revenue source since the 59th Legislature adjourned.

Revenue Projection: This section consists of a graph and accompanying data table. The line graph shows the amount of actual collections and the projected amounts for fiscal years 2006 and 2007. Total collections are depicted by a dark line while general fund collections are shown by a lighter line. The data table contains historic information about this data source since 1983 including: 1) actual total collections; 2) actual general fund collections; 3) projected total and general fund amounts for fiscal 2006 and 2007; and 4) the yearly percentage change in general fund.

HJR 2 Comparison: This section includes a table that shows the HJR 2 revenue estimate, the RTIC revenue estimate recommendations, and the difference between the two estimates for fiscal 2006, 2007 and a biennium total.

CORPORATION INCOME TAX

Revenue Description:

The corporation income tax is a license fee levied against a corporation's net income earned in Montana. The corporation income tax is imposed on corporations that, for reasons of jurisdiction, are not taxable under a license tax. Factors that affect corporation license tax receipts include tax credits and the audit efforts by the Department of Revenue. As with individual income tax, all forecasts are adjusted for allowable credits.

Applicable Tax Rate(s):

The tax rate is 6.75%, except for corporations making a "water's edge" election (see 15-31-322, MCA), who pay a 7.0% tax on their net income.

Distribution:

Prior to the enactment of SB 442 by the 2005 legislature, the Department of Revenue could distribute up to 0.45% of this general fund revenue source as an administrative assessment to a state special revenue account to pay debt service on the loan used to fund a POINTS replacement computer system (enacted in Senate Bill 271 by the 2003 legislature). SB 442 eliminated this provision. Beginning fiscal 2006, all corporation tax revenue is distributed to the general fund.

Collection Frequency:

Monthly, Quarterly, and Annually

Statutory Reference:

Tax Rate (MCA) – 15-31-121,

Tax Distribution (MCA) – 15-31-121, 15-1-501(1)

Date Due – by the 15th day of the fifth month following the close of the corporate fiscal year (15-31-111, 15-31-502). Estimated taxes due April 15th, June 15th, September 15th, and December 15th (15-31-502).

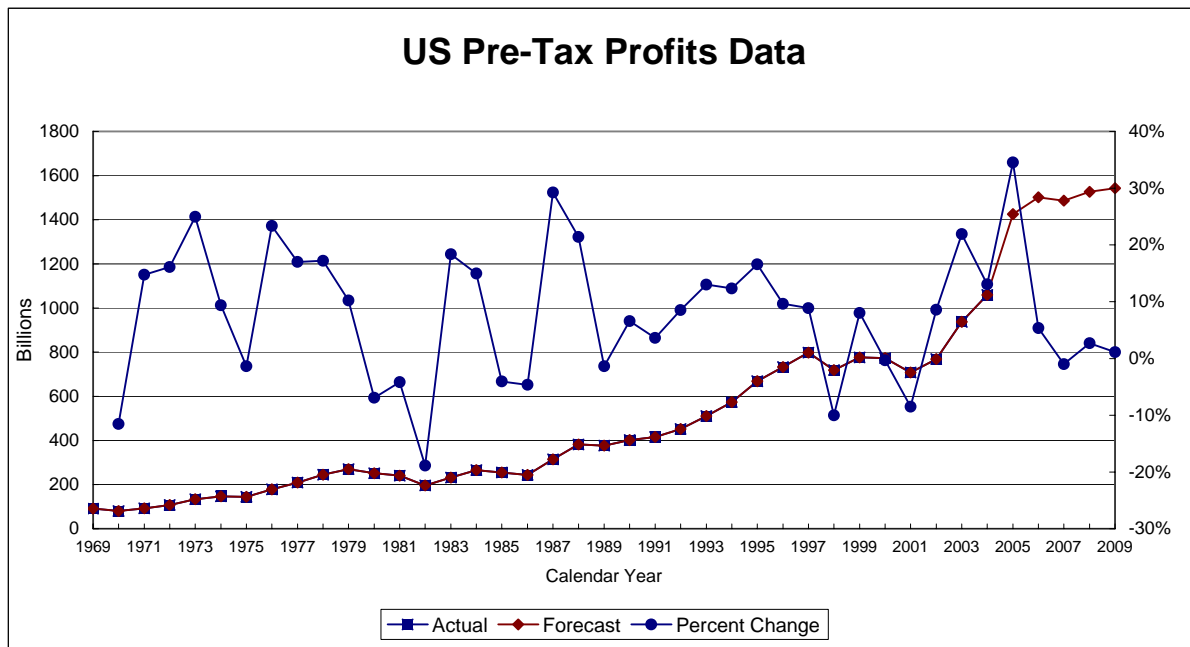
Additional Information Since Adjournment:

The corporation tax estimates are recommended to increase by \$28.6 million, or 17.8 percent, over the HJR 2 estimates for the 2007 biennium. Since the last legislative session, new data has shown higher corporation tax collections. An additional year of data from both the state accounting, budgeting, and human resource system (SABHRS) and return data from the Department of Revenue (DOR) shows a

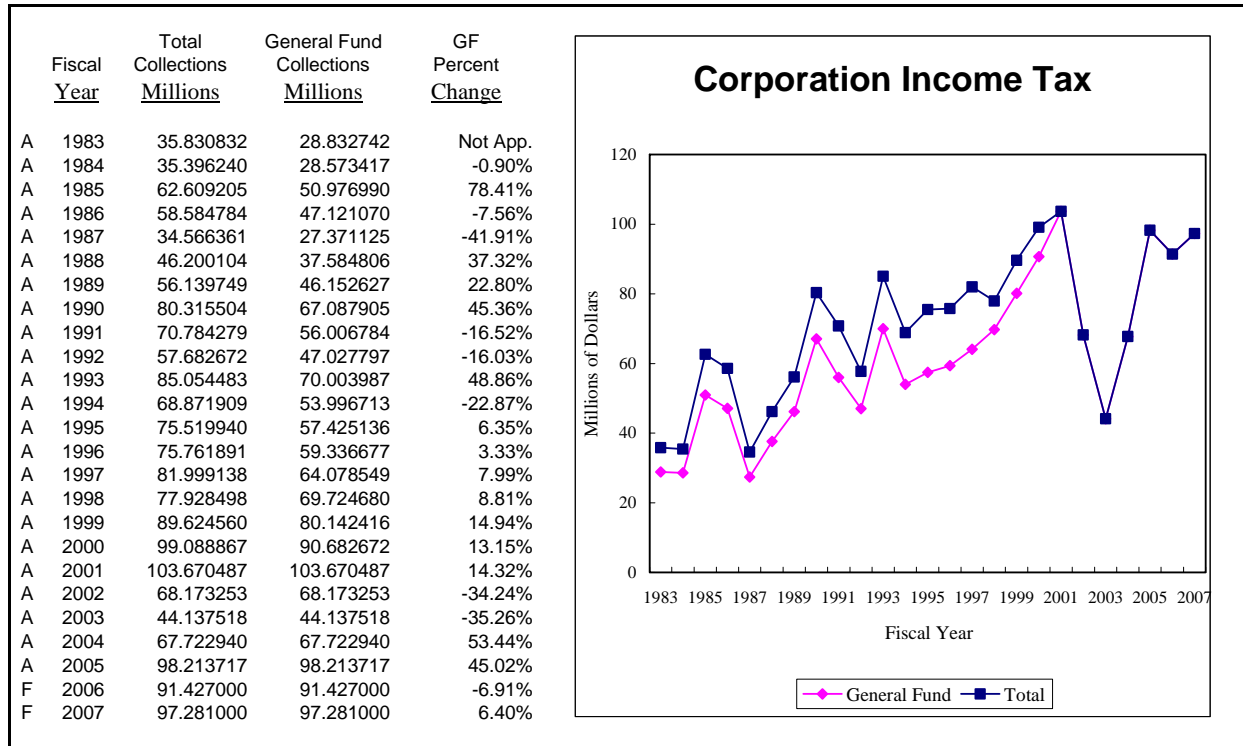
dramatic increase in collections for this source. The recommendations are \$91.4 million in fiscal year 2006 and \$97.3 million in fiscal year 2007.

Total corporation tax collections are expected to increase to \$99.8 million in fiscal year 2006, but a carry-over of \$8.4 million in unusual refunds is anticipated to reduce the total collections. The refunds did not occur in the 2005 biennium as assumed in the previous projection, and the DOR believes they may be issued in fiscal year 2006. Before the refund adjustment, collections from corporation license tax are expected to increase 1.6 percent over actual fiscal year 2005 collections of \$98.2 million. Collections for fiscal year 2007 are then expected to decrease by 2.5 percent.

The DOR provides the estimates for corporation license tax audit collections. The recommendation for the 2007 biennium is \$7.0 million, \$3.5 million each fiscal year. In the 2005 biennium, actual audit collections, consisting of audit payments and interest and penalty payments, equaled \$28.8 million (\$14.2 million in fiscal 2004 and \$10.6 million in fiscal 2005). The DOR estimates were used to create the recommendation, however the estimates are significantly understated when considering past collections. Additionally, the high audit collections in the 2005 biennium combined with the conservative estimates, distort the projected trend and make total growth appear lower than actually anticipated.



U.S. pre-tax corporation profits, as provided in the November 2005 Global Insight publication, are used in the development of the corporation license tax estimate. Consequently, the trend associated with the corporation license tax estimate is similar to the trend presented in the pre-tax profits series. As seen in the figure to the right, profits increased by almost 35.0 percent in calendar year 2005. In calendar year 2006 and 2007, growth slows significantly to 5.4 percent and negative 1.0 percent respectively.

Revenue Projection:**HJR2 Comparison:**

| Revised HJR 2 General Fund Revenue Estimates (In Millions) | | | | | | | | | | |
|--|-------------|-------------|-------------|-----------|----------------------|-------------|-----------|-------------|-------------|----------|
| Revenue Source | Actual | HJR 2 | | | RTIC Recommendations | | | Difference | | |
| | Fiscal 2005 | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium |
| Corporation Tax | \$98.214 | \$81.148 | \$78.997 | \$160.145 | \$91.427 | \$97.281 | \$188.708 | \$10.279 | \$18.284 | \$28.563 |

INDIVIDUAL INCOME TAX

Revenue Description:

The tax is levied against taxable income, which is defined as Montana personal income adjusted for exemptions and deductions. Once tax liability is determined, the amount of tax due is computed by subtracting allowable credits.

Applicable Tax Rate(s):

Tax rates vary from 1.0% to 6.9%, depending on the level of taxable income. Tax brackets, personal exemption amounts, and the standard deduction are adjusted by the rate of inflation in each year. SB 407, enacted by the 2003 legislature, created a new capital gains income tax credit. As a result, the tax rate on capital gains income is less than the tax rate on ordinary income by 1 percent in tax years 2005 and 2006, and by 2 percent in tax year 2007 and beyond.

Distribution:

Prior to the enactment of SB 442 by the 2005 legislation, beginning fiscal 2004 through fiscal 2011, the Department of Revenue could distribute up to 0.45% of this general fund revenue source as an administrative assessment to a state special revenue account to pay debt service on the loan used to fund a POINTS replacement computer system (enacted in Senate Bill 271 by the 2003 legislature). SB 442 eliminated this provision. All proceeds are deposited into the general fund.

Collection Frequency:

Withholding taxes are collected monthly, bi-weekly, and weekly, and estimated taxes are collected quarterly.

Statutory Reference:

Tax Rate (MCA) – 15-30-103

Tax Distribution (MCA) – 15-1-501(1)

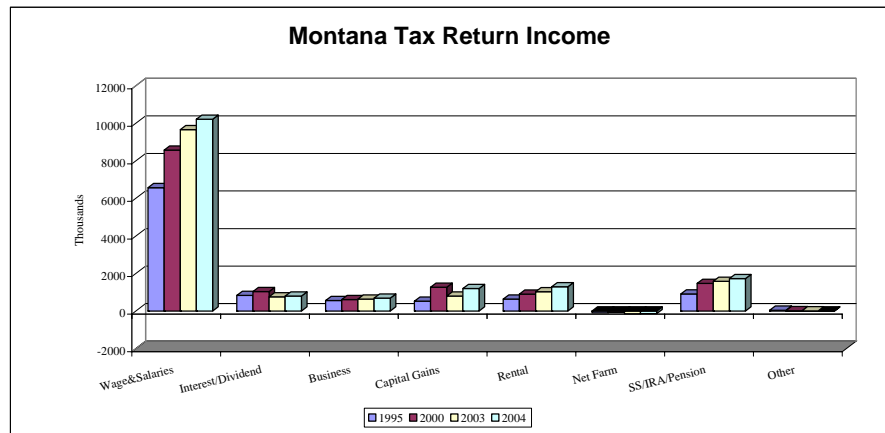
Date Due – 15th day of the fourth month of the filer's fiscal year (15-30-144). Withholding taxes due monthly, quarterly, or on an accelerated schedule depending on income (15-30-204).

Estimated taxes due on the 15th day of the 4th, 6th, and 9th month and the month following the close of the tax year.

Additional Information Since Adjournment:

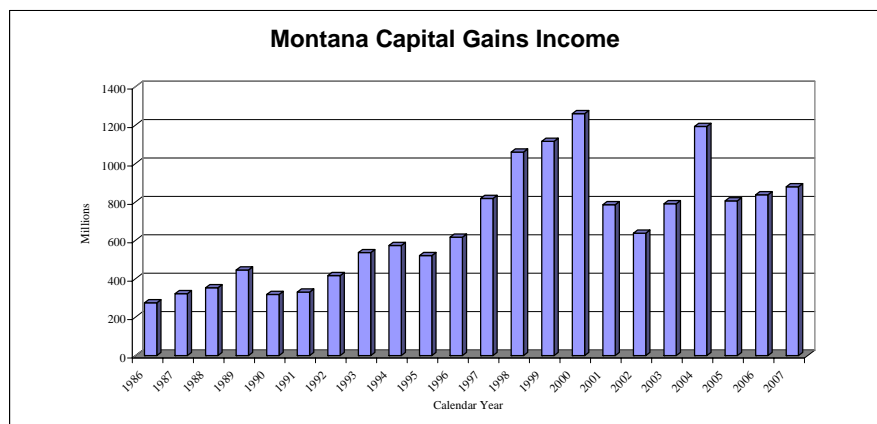
The recommendation for individual income taxes is an increase of \$153.2 million, or 12.4 percent, over the HJR 2 estimates for the 2007 biennium. Unexpectedly high collections in fiscal year 2005, an additional year of tax return data, coupled with new data from the Global Insight forecasting service were used to develop the recommendation for an upward adjustment to the individual income tax projection. Recommendations for the biennium include \$677.8 million in fiscal 2006 and \$712.6 in fiscal 2007.

Return data for the 2004 tax year became available in November. The figure to the right depicts the income category results of this data and compares it to data from tax years 1999, 2000, and 2003. As seen in this figure, most income sources experienced growth over tax year 2003. While growth in wages and salaries was expected, growth in dividends, capital gains, and rents and royalties was greater than anticipated.



New information was used in the development of the individual income tax recommendations. Several modifications were made to the assumptions used in HJR 2. The economic assumptions used to produce the recommendation include:

1. Wage and salary income: increased by 5.8 percent in tax year 2004. HJR 2 assumed growth of 4.5 percent in tax years 2005 through 2007. While the assumption for 2004 was accurate, information provided by Global Insight shows wages and salaries growing at a rate of 8.4 percent in tax year 2005, 5.7 percent in tax year 2006, and 4.8 percent in tax year 2007.
2. Dividend income: increased by 27.6 percent in tax year 2004. Growth for tax year 2004 was estimated to be 12.0 percent. The assumption is that growth in this income source is the result of federal tax changes that reduced the tax on dividend income to 15.0 percent through tax year 2009. While a similar spurt of growth is not anticipated in future years, increased dividend income is expected during the period of preferential tax treatment. As a result, HJR 2 growth rates were not changed, but they are applied to the higher base of tax year 2004.
3. Capital gains income: increased by 50.9 percent in tax year 2004. As apparent in the figure to the right, income from capital gains nears the magnitude seen in the late 1990's. No growth had been assumed in tax year 2004 in HJR 2. Capital gains income includes the gains incurred from the sales of many forms of capital including land and equity investments. The tax return data provided by the DOR is provided in aggregate by taxpayer and does not segregate the sources of the gains. Regardless, it is assumed the significant increase of capital gains in



the 2004 tax year results from individuals who have taken advantage of the new federal preferential tax treatment. Such significant increases are not expected to continue in future tax years. As a result, the recommendation uses the 2004 tax year as a base and assumes a return to the long-term trend line into the future.

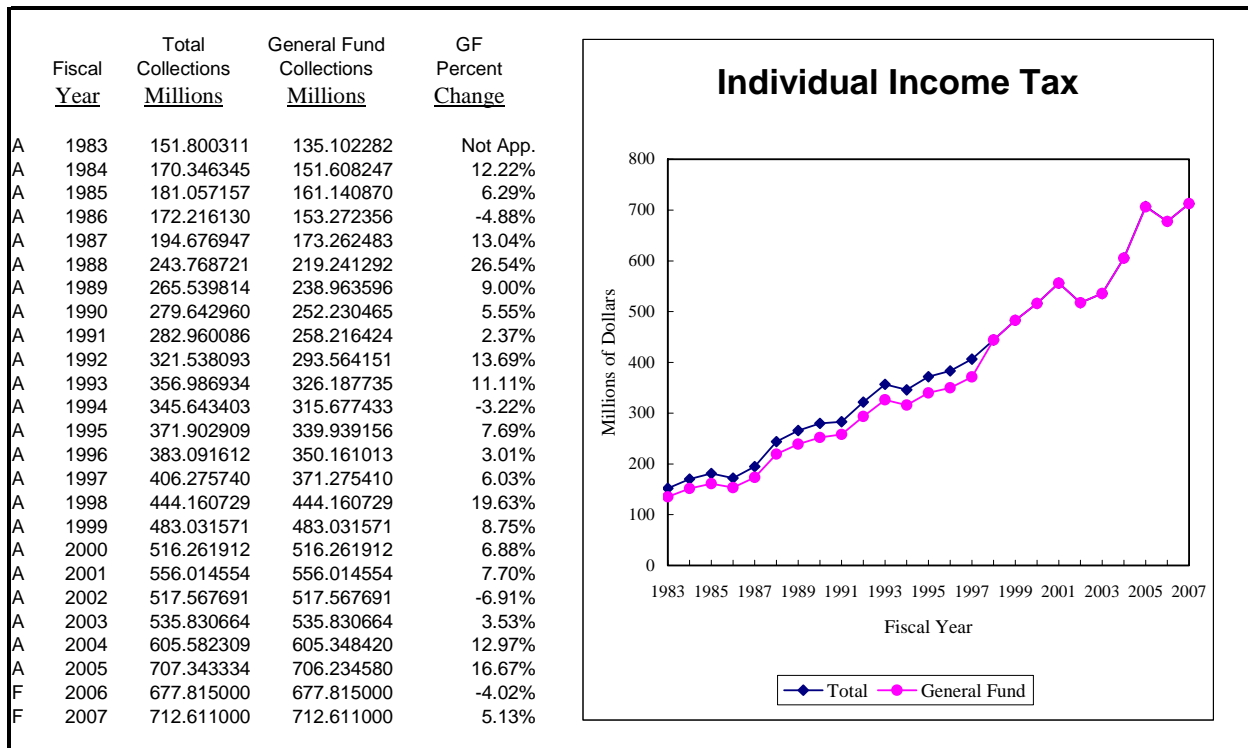
4. Rents and royalty income: increased by 25.8 percent in tax year 2004. The growth assumption for this source of income was 10.2 percent for the 2004 tax year. As in the case of capital gains data, this category includes three sources of income: rents, partnership, and royalty income. The income data is provided as an aggregate figure. There is no method for determining whether rental, partnership, or royalty income is responsible for the significant increase. However, the dramatic increase in oil and natural gas production in the state suggests that the increase can be attributed to royalty income. As long as oil and gas production remain at current levels, the assumption is that rent and royalties income will also be strong. Accordingly, HJR 2 growth rates were not changed but they are applied to the higher base of tax year 2004.

In addition to modifying these growth rates, the recommendation includes changes to the population adjustment factor and the non-resident filers multiplier. These factors were adjusted slightly to agree with new data provided through Global Insight.

The DOR provides the estimates for individual income tax audit collections. The recommendation for the 2007 biennium is \$45.0 million. In the 2005 biennium, actual audit collections, consisting of audit payments and interest and penalty payments, equaled \$67.1 million (\$29.9 million in fiscal 2004 and \$37.2 million in fiscal 2005). The DOR estimates were used to create the recommendation, however the estimates are significantly understated when considering past collections. Additionally, the high audit collections in the 2005 biennium combined with the conservative estimates, distort the projected trend and make total growth appear lower than actually anticipated.

Estimated refunds for the 2005 tax year are expected to be higher than assumed in HJR 2 as a result of two factors related to the enactment of SB 407. The legislation became effective at the beginning of the 2005 tax year. In aggregate, this legislation was expected to reduce individual income tax collections in fiscal 2005 and subsequent years. First, the DOR distributed new withholding tables to the employers at the beginning of the 2005 tax year, followed by a revised tax table at a later date. There is still uncertainty when the new withholding tables, were implemented by employers in tax year 2005. Consequently, failure to use the new tables may result in additional refunds in fiscal 2006. Next, discussions with accounting firms indicate that some taxpayers were advised to make estimated payments, unadjusted for the impact of SB 407. Such actions would mean that taxpayers were paying taxes at too high a rate. This action would also result in additional refunds in fiscal 2006. The refund impacts of both situations is included in the recommendation.

Collectively, these changes produce a recommendation of \$677.8 million in fiscal year 2006. This is an increase of 11.6 percent from the HJR 2 estimate. In fiscal year 2007, the recommendation is \$712.6 million. The estimate is 13.1 percent greater than the HJR 2 estimate.

Revenue Projection:**HJR2 Comparison:**

| Revised HJR 2 General Fund Revenue Estimates (In Millions) | | | | | | | | | | |
|--|-------------|-------------|-------------|-------------|----------------------|-------------|-------------|-------------|-------------|-----------|
| Revenue Source | Actual | HJR 2 | | | RTIC Recommendations | | | Difference | | |
| | Fiscal 2005 | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium |
| Individual Income Tax | \$706.235 | \$607.178 | \$630.060 | \$1,237.238 | \$677.815 | \$712.611 | \$1,390.426 | \$70.637 | \$82.551 | \$153.188 |

OIL AND NATURAL GAS PRODUCTION TAX

Revenue Description:

The oil and natural gas production tax is imposed on the production of petroleum and natural gas in the state. Gross taxable value of oil and natural gas production is based on the type of well and type of production.

Applicable Tax Rate(s):

The oil and natural gas production tax has numerous tax rates depending on several factors. These factors include whether the oil or gas is produced from a stripper well, a stripper incentive well, from a well initially drilled before 1999 or after, from a well newly drilled within the last year or 18 months, and whether the interest being taxed is the working interest or the royalty interest. The Board of Oil and Gas Conservation imposes an additional privilege and license (P & L) tax on all oil and natural gas tax rates. For the 2007 biennium, the P&L tax rate is 0.26 percent. HB 758 (enacted by the 2005 legislature) allows an additional tax rate of 0.04 percent to generate revenue for local impacts for local governments. The two taxes may not exceed 0.3 percent. HB 535 (enacted by the 2005 legislature) created out of the "stripper well exemption" category a new tax category called "stripper well bonus" which is defined as production from a stripper well that produces three barrels a day or less. The figure to the right shows tax rate percentages for each type of pre-1999 oil and post-1999 oil, excluding the P & L tax and the new Local Impact tax. The quarterly tax rates on stripper production and on incremental production are lower than that for regular production unless the price of West Texas Intermediate averages above \$30 for the quarter.

Similarly, the quarterly tax rate for stripper well exemption production (1-3 barrels a day) is lower than that for regular production unless the price of West Texas Intermediate averages above \$38 for the quarter.

| Oil and Natural Gas Production Tax Rates * | |
|--|-----------|
| Oil Production | Tax Rates |
| <u>Working Interests</u> | |
| Pre 99 after 12 Months (Regular) | 12.50% |
| Post 99 First 12 Months (New) | 0.50% |
| Post 99 after 12 months (Regular) | 9.00% |
| Stripper 4-10 barrels per day | 5.50% |
| Stripper 11-15 barrels per day | 9.00% |
| Stripper Well Exemption (1-3 barrels per day) | 0.50% |
| Pre99 Horizontal after 18 months | 12.50% |
| Post 99 Horizontal first 18 months | 0.50% |
| Post 99 Horizontal after 18 months | 9.00% |
| Incremental - secondary | 8.50% |
| Incremental - tertiary | 5.80% |
| Pre99 Horizontal Recom - after 18 months | 12.50% |
| Post99 Horizontal Recom - first 18 months | 5.50% |
| Post99 Horizontal Recom - after 18 months | 9.00% |
| <u>Royalty Interests</u> | 14.80% |
| Natural Gas Production | |
| <u>Working Interests</u> | |
| Pre-99 after 12 months | 14.80% |
| Post 99 first 12 months | 0.50% |
| Post 99 after 12 months | 9.00% |
| Pre 99 stripper wells | 11.00% |
| Horizontal first 18 months | 0.50% |
| Horizontal after 18 months | 9.00% |
| <u>Royalty Interests</u> | 14.80% |
| If the West Texas price of oil exceeds \$30/bbl in a quarter, the rates for stripper | |
| * Excluding the P & L and Local Impact tax rates | |

Distribution:

Once the oil and natural gas production taxes have been collected, the revenue is first distributed based on the amounts collected from the P & L and Local Impact taxes. The amounts from the P & L tax are distributed to the: 1) Board of Oil and Gas Conservation; and 2) the Legislative Services Division - \$50,000 only in the 2007 biennium. The amounts from the Local Impact tax are distributed to the oil, gas, and coal natural resource state special revenue account. The amounts received by the Board and the oil, gas, and coal natural resource account vary based on a sliding scale based on the P & L tax set by the Board. Counties producing oil receive the next share of the total revenue with each county having its own distribution percentage of total revenue, including the revenue generated by the P & L and Local

Impact taxes. The remainder of the revenue is distributed to other state accounts in the following manner:

Fiscal 2004 through Fiscal 2011

- Coal bed methane account – 1.23%
- Reclamation and development account – 2.95%
- Orphan share account – 2.95%
- University system 6 mill levy account – 2.65%
- General fund – the remainder (90.22%)

The distributions of county shares and the amount of oil and natural gas production tax revenue deposited in the oil, gas, and coal natural resource account are statutorily appropriated and are based on the statutorily set percentages for each county.

Collection Frequency:

Quarterly: The oil and natural gas production tax is due 60 days after the end of the production quarter.

Statutory Reference:

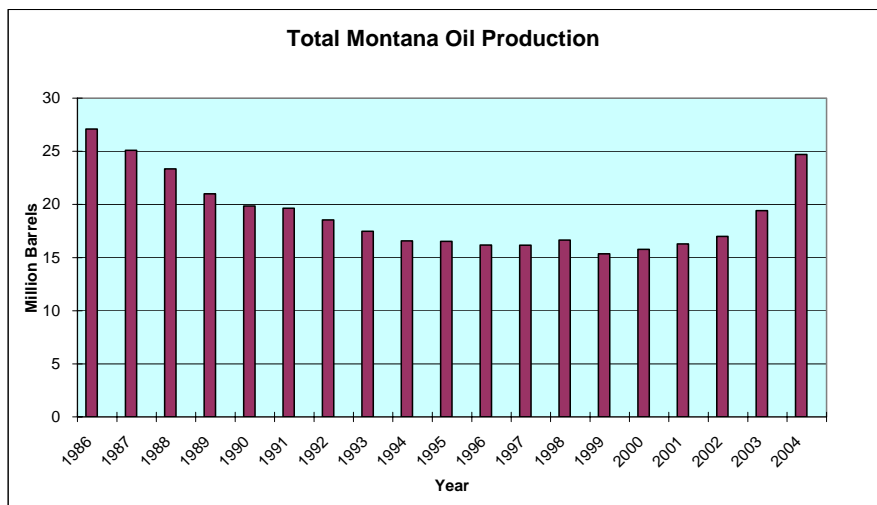
Tax Rate (MCA) – 15-36-30. Privilege and license tax – 82-11-131, Administrative Rules 36.72.1242

Tax Distribution (MCA)– 15-36-331(4), 15-36-332(2&3) (to taxing units)

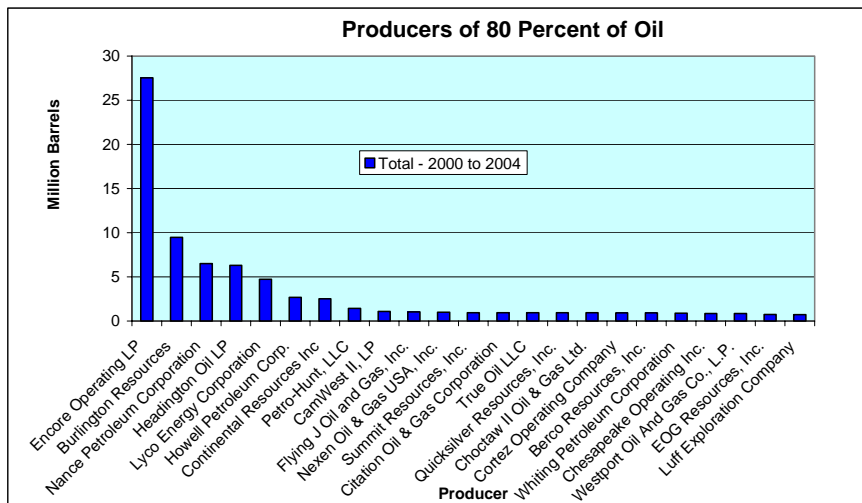
Date Due – within 60 days after the end of the calendar quarter (15-36-311(1))

Additional Information Since Adjournment:

The recommendations for the oil and natural gas estimates are for an increase of \$38.2 million in fiscal 2006 and \$27.6 million in fiscal 2007 for a total of \$65.8 million above HJR 2 estimates for the 2007 biennium. The oil estimates were based on assumptions of 34.9 million barrels at \$57.79/per barrel in fiscal 2006, and 35.5 million barrels at \$50.49/per barrel in fiscal 2007. The natural gas estimates were based on assumptions of 102.2 million MCF at \$8.35/per MCF in fiscal 2006, and 101.1 million MCF at \$8.10/per MCF in fiscal 2007.



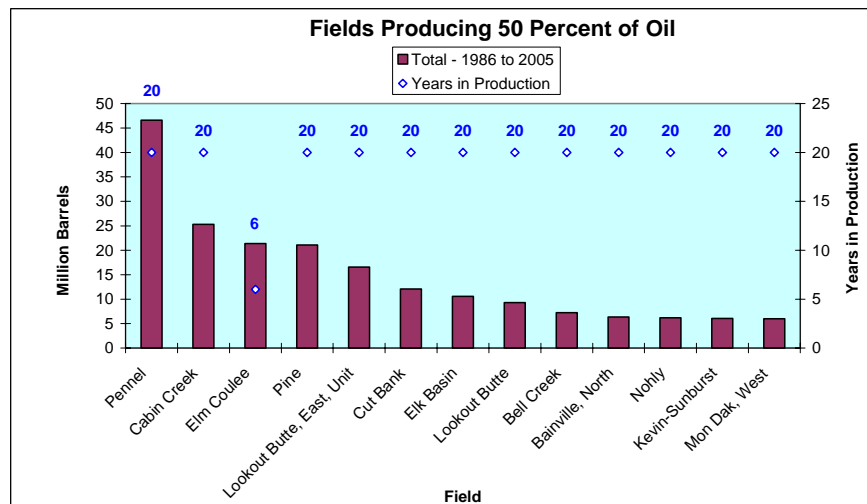
The oil industry in Montana has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. The figures on this page show various aspects of this industry.



Data from the Board of Oil and Gas Conservation enabled an isolation of production for each field. Analysis of the field data indicated that the majority of increased production is from the relatively new Elm Coulee field in Richland County. Production from fields other than Elm Coulee grew an average of 2.2 percent for the past five years, indicating that most of the increase in production is from the Elm Coulee field. Industry personnel state that although this field has yet to

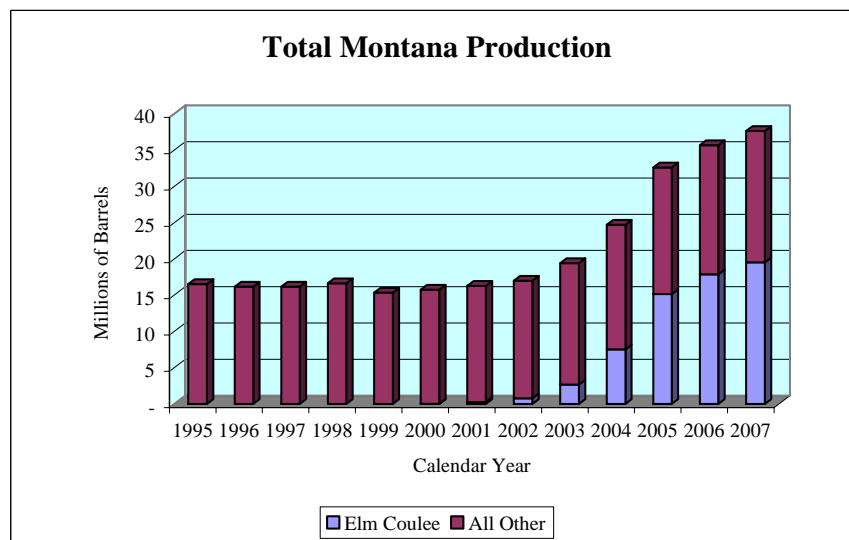
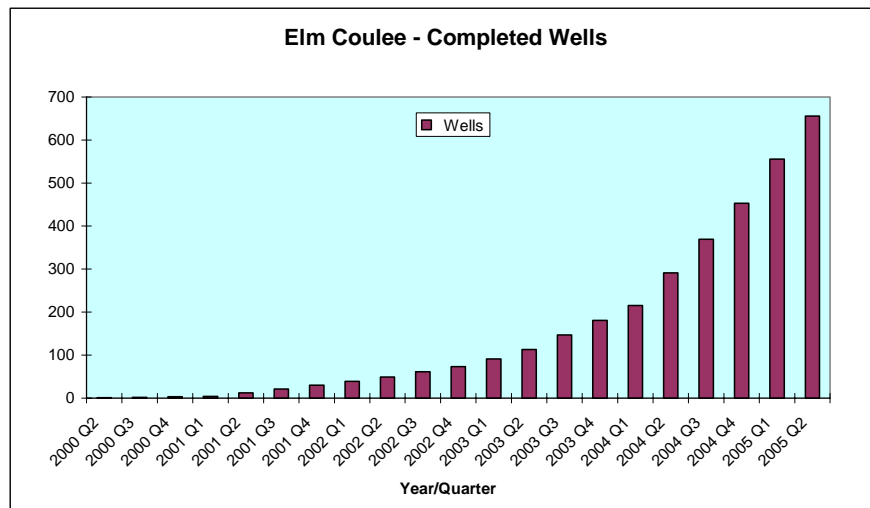
be fully defined, it probably is nearing that stage. When this occurs, fewer new wells will be spudded (drilling initiated).

Existing wells will then follow a production decline curve unique to the characteristics of the field. Fields tapped through horizontal drilling, such as Elm Coulee, tend to be depleted more rapidly than those tapped vertically. The importance of Elm Coulee is shown in the figure below. The figure shows that even though the field has been in production for only six of the last 20 years, it ranks third in total production out of the major fields that have been producing for the entire 20 years. The Elm Coulee field first began production in 2000. From that time through August 2005, 197 wells had been completed and 48 wells have been spudded. Future production from completed wells can be estimated by developing a normalized production decline curve from the producing wells.



In doing so, the difficulty of having different starting time for each well can be eliminated by averaging each well's production from a common time point. The result is a curve that represents the average production of wells in the Elm Coulee field by month of production. Knowing monthly production from each well and the date it was placed into production are essential for estimating oil tax revenue because tax rates vary based on the length of time a well has been in production.

Production from future wells can be estimated by applying the production curve coefficients to an estimate of future spudded wells. The figure below shows the history of completed wells since the beginning of this field.

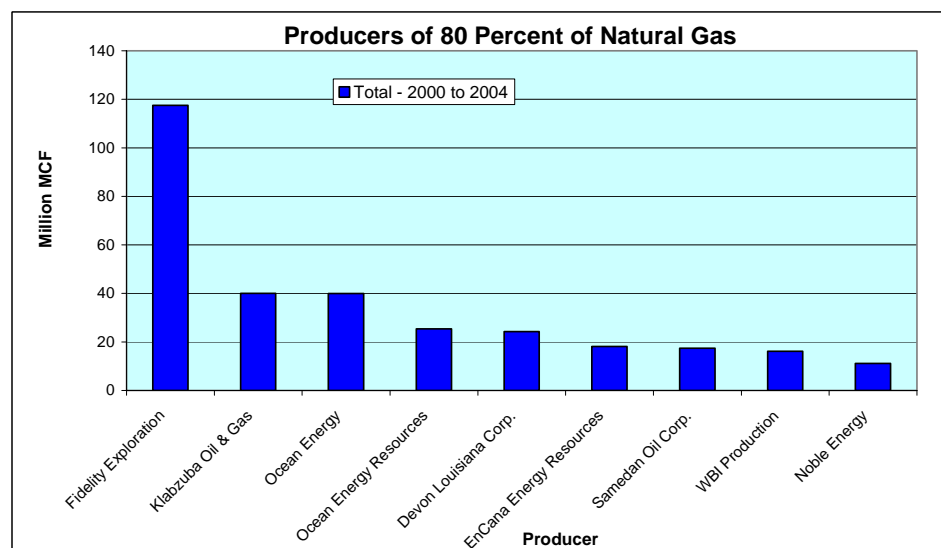
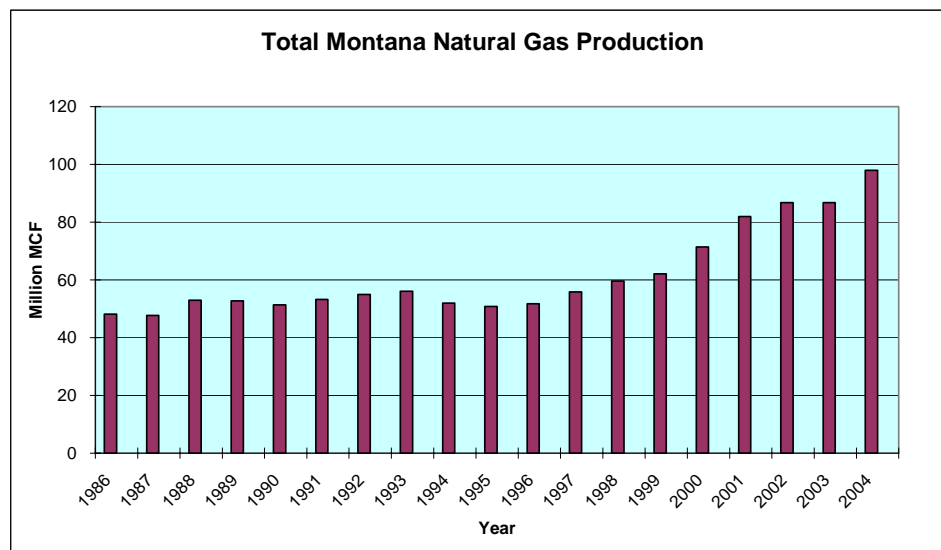


The importance this one field plays in the oil production tax estimate for the 2007 biennium is seen in the figure above. For this biennium it is estimated that, 51 percent of total statewide production comes from Elm Coulee.

In determining a price estimate for oil, Global Insight's future forecasts of West Texas Intermediate crude were used. In general, the price of WTI oil is expected to decrease from \$63/barrel to \$50/barrel during the 2007 biennium. Because the price received from Montana oil is normally lower than the quoted price for WTI, an adjustment to the WTI price was applied based on historical comparisons between the two prices.

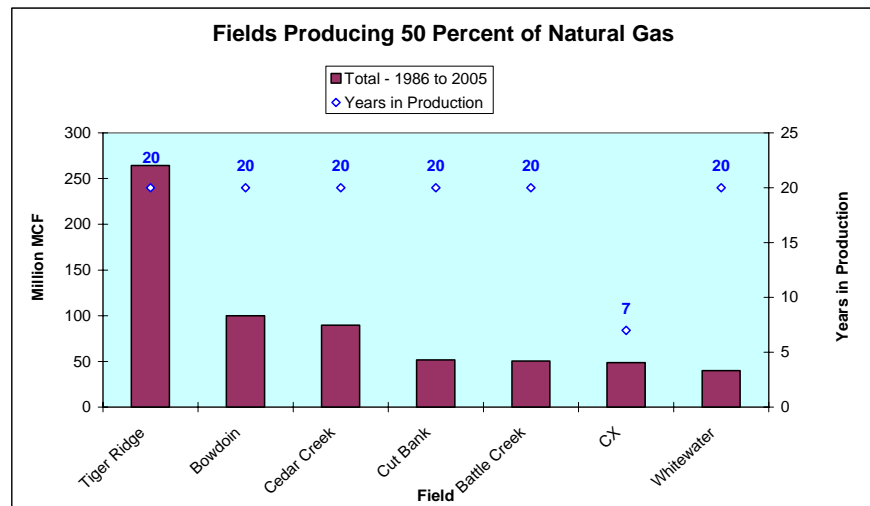
Natural Gas

The natural gas industry in Montana has also been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. The figures on this page show various aspects of this industry. Data from the Board of Oil and Gas Conservation indicate that the majority of increased production is from the relatively new CX field in Big Horn County and the Elm Coulee field in Richland County. Other fields that exhibit increasing production are the Bowdoin and Cedar Creek fields, the second and third largest producing fields, respectively.

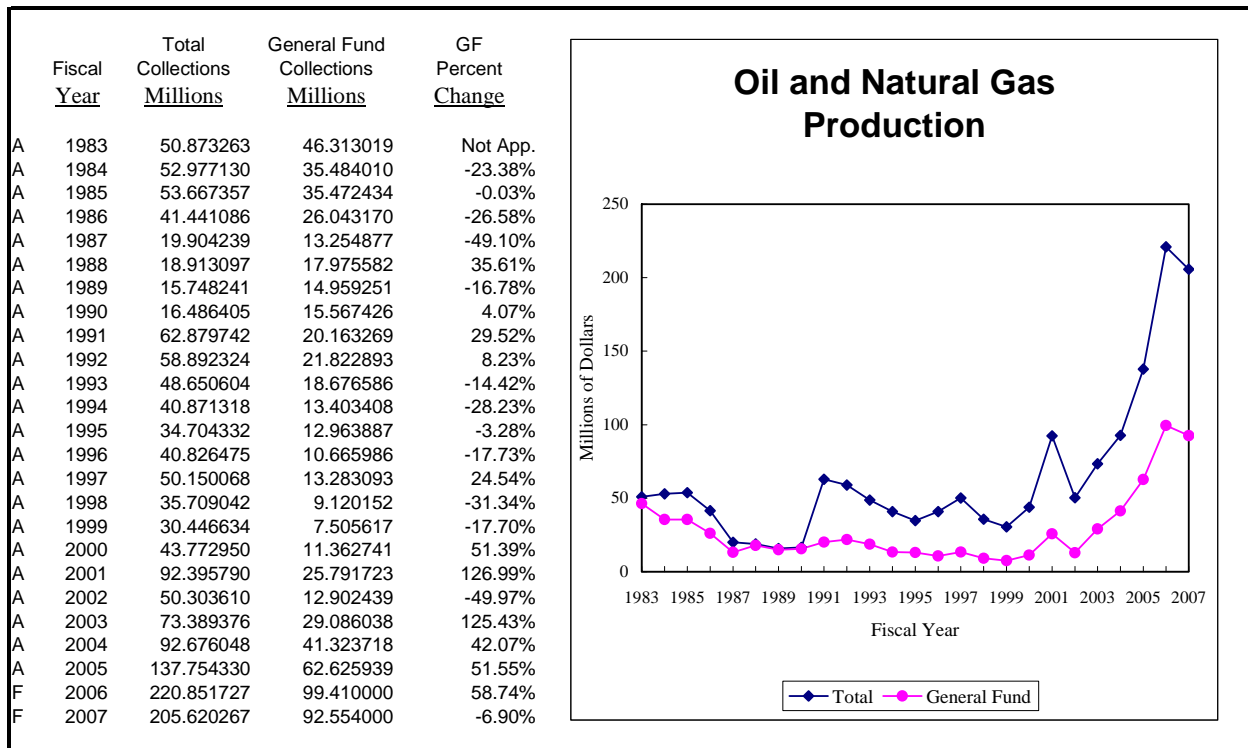


Since its peak production in 1999, production from Tiger Ridge, the largest producing field, has declined. By excluding production from fields with increasing production, it was found that production from the remaining fields has been decreasing since 2001. Of the fields with increasing production, most is

coming from the CX and Elm Coulee fields. The importance of the CX field is shown in the figure below. The figure shows that even though the CX field has been in production for only seven of the last 20 years, in ranks sixth in total production out of the major fields that have been producing for the entire 20 years. A similar analysis to that used for oil can also be used for natural gas. The CX field began production in April 1999 and in 2004 produced 12.3 million MCF. From that time through August 2005, 543 wells have been completed, 95 of which were completed in 2005. In 2005, 25 wells have been spudded. The Elm Coulee field began production in 2000 and in 2004 produced 5.7 million MCF. As with oil, the development of a normalized production curve from individual wells eliminates the difficulty of having different starting time for each well by averaging each well's production from a common point in time. The result is a curve that represents the average production of wells in the CX field by month of production.



Global Insight does not provide future estimates of natural gas prices. In determining a price estimate for natural gas, Henry Hub spot market future forecasts were used. In general, the price is expected to decrease to \$9.19/MCF at the end of the 2007 biennium. Because the price received from Montana natural gas is normally lower than the national price for natural gas, an adjustment was applied based on historical comparisons between the two prices.

Revenue Projection:**HJR2 Comparison:**

| Revised HJR 2 General Fund Revenue Estimates (In Millions) | | | | | | | | | | |
|--|-------------|-------------|-------------|-----------|----------------------|-------------|-----------|-------------|-------------|----------|
| Revenue Source | Actual | HJR 2 | | | RTIC Recommendations | | | Difference | | |
| | Fiscal 2005 | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium |
| Oil Severance Tax | \$62.626 | \$61.192 | \$64.958 | \$126.150 | \$99.410 | \$92.554 | \$191.964 | \$38.218 | \$27.596 | \$65.814 |

PROPERTY TAX

Revenue Description:

Montana law requires counties to levy a county equalization levy of 55 mills, a state equalization levy of 40 mills and 6 mills for the university system against all taxable value in each county. A mill levy of 1.5 mills is also applied against all property in the five counties with a vo-tech college. Taxable value is defined as the market value of statutorily defined property times a statutory tax rate. Property valued at market value includes personal property, utility property, railroad and airline property, and mineral net and gross proceeds. The assessed value of residential and commercial real estate is the market value phased in over the reappraisal cycle. Agricultural land and timberland are valued on a productivity basis and their values are also phased in over the reappraisal cycle. Beginning January 1, 2003, livestock is no longer taxed.

Beginning January 1, 2003, residential and commercial property as well as agricultural land and timberland reflect the impact of a new reappraisal on market values. The current reappraisal cycle is 6 years, during which increases in property values will be phased in by 1/6th per year. Property that declines in value will be assessed immediately at its new reappraised value. The impact of reappraisal on assessed values increased the market value of the average residence by 20.2 percent. The equivalent increases for commercial property were 18.5 percent and for agricultural land by 15.3 percent.

The 2003 legislature passed a reappraisal mitigation bill - SB 461 (see below). Beginning in tax year 2003, reappraisal values were phased in over the next six years. The new tax rates and the new homestead and comstead exemptions are shown in the accompanying table:

In addition to the tax on property, this revenue component includes collections from "non-levy" sources that are distributed on the basis of mills levied by taxing jurisdictions. These non-levy sources include the state share of coal gross proceeds taxes, federal forest revenues, and other smaller revenue sources.

| SB 461 Tax Rates and Exemption Percentages for Class 4 Residential and Commercial Property | | | | |
|---|-------------|-------------------------------------|--|------------------------------------|
| Fiscal Year | Tax Rate | Class 4 Residential Exemption | Class 3 Multi Family Housing Exemption | Class 4 Commercial Exemption |
| 2003 (prior law) | 3.46% | 31.0% | 31.0% | 13.0% |
| 2004 | 3.40% | 31.0% | 31.0% | 13.0% |
| 2005 | 3.30% | 31.4% | 31.4% | 13.3% |
| 2006 | 3.22% | 32.0% | 32.0% | 13.8% |
| 2007 | 3.14% | 32.6% | 32.6% | 14.2% |
| 2008 | 3.07% | 33.2% | 33.2% | 14.6% |
| 2009 | 3.01% | 34.0% | 34.0% | 15.0% |

This source also includes the state's share of protested taxes paid by centrally assessed companies. Should the state fail in its defense of the taxation of these companies, the protested taxes must be returned to the taxpayer. With the enactment of Senate Bill 87 by the 2005 legislature, one-half of protested taxes from the state's 95 mills is deposited to the general fund and one-half is deposited to a fiduciary fund.

Applicable Tax Rate(s):

Each property class has its own tax rate that is applied to assessed value to produce a taxable value. For every \$1,000 in taxable value, each mill generates \$1 in state property taxes.

Distribution:

Most property tax receipts are deposited into the general fund. There are two exceptions: 1) revenue associated with the 6-mill university levy is deposited to the state special revenue fund; and 2) half of the revenue paid under protest for centrally assessed property is deposited in a fiduciary fund.

Collection Frequency:

Monthly with significant state deposits in December and June.

Statutory Reference:

Tax Rate (MCA) – 20-9-331(1), 20-9-333(1)

Tax Distribution (MCA) - 20-9-331(1), 20-9-333(1)

Date Due – one-half of taxes due November 30th and one-half due May 31st (15-16-102(1)), county treasurers must remit to the Department of Revenue within the first 20 days of each month money received in the previous month (15-1-504(1))

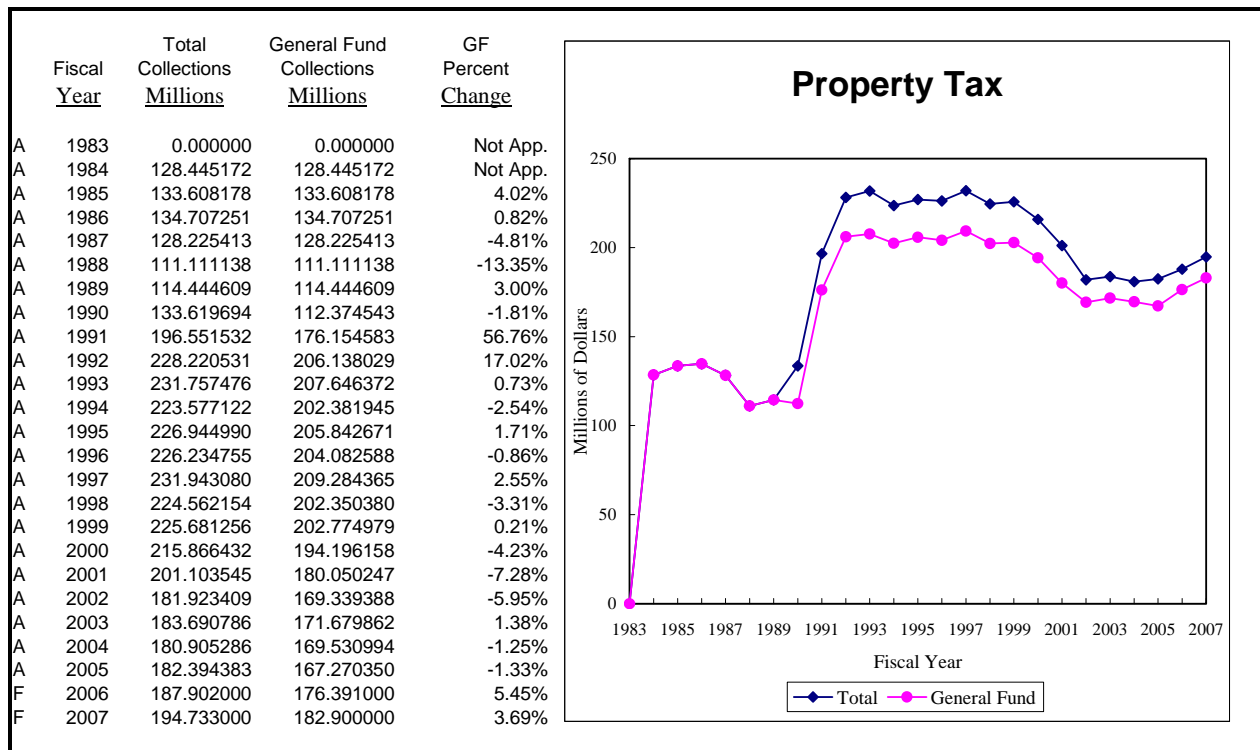
Additional Information Since Adjournment:

Property tax revenue for the 2007 biennium is recommended to increase by \$5.4 million or 1.5 percent over the HJR 2 revenue estimate. Since the last legislative session, taxable values for tax year 2005 (fiscal 2006) have become known and can be used to recalculate estimated property taxes for the biennium (see the table below).

| Property Taxable Values | | | | |
|-------------------------|-----------------------|-----------------|-----------------|-----------------|
| Tax Class | Name | TY 2005 | FY 2006 | FY 2007 |
| Class 1 | Net Proceeds | \$2,694,216 | \$2,694,216 | \$2,694,216 |
| Class 2 | Gross Proceeds | 13,045,195 | 13,045,195 | 13,045,195 |
| Class 3 | Ag Land | 140,988,242 | 140,988,242 | 140,847,254 |
| Class 4 | Real Property | 1,129,794,467 | 1,129,794,467 | 1,174,986,246 |
| Class 5 | Co-ops | 34,611,220 | 34,611,220 | 34,611,220 |
| Class 7 | Independent Telephone | 953,438 | 953,438 | 953,438 |
| Class 8 | Personal Property | 123,054,946 | 124,972,142 | 130,096,000 |
| Class 9 | Utilities | 238,766,675 | 238,766,675 | 238,527,908 |
| Class 10 | Timber Land | 6,793,765 | 6,793,765 | 6,793,762 |
| Class 12 | RR & Airlines | 44,267,220 | 44,267,220 | 43,580,253 |
| Class 13 | Electric, TelCom | 122,845,989 | 122,845,989 | 122,845,989 |
| Class 14 | Wind Generation | 0 | 0 | 6,412,500 |
| Total | | \$1,857,815,373 | \$1,859,732,569 | \$1,915,393,981 |

There are three notable changes to the property tax revenue estimate:

1. Actual tax year 2005 (fiscal 2006) statewide taxable value increased over the prior year by 4.4 percent, whereas the HJR2 revenue estimate projected a 2.5 percent increase.
2. The growth changes in tax year 2005 and new information warrant adjusting the estimated tax year 2006 (fiscal 2007) growth rates for class 8, business equipment from 2.9 percent to 4.1 percent; and class 13, telecommunication and electric generation property from -1.6 percent growth to 0 percent, or no change in taxable value.
3. Protested property taxes (net of settled cases) are estimated to be \$2.4 million higher each year of the biennium than the SB 87 estimate. Fifty percent of this amount is removed from the general fund, so this is an offset of \$1.2 million a year.

Revenue Projection:**HJR2 Comparison:**

| Revised HJR 2 General Fund Revenue Estimates (In Millions) | | | | | | | | | | |
|--|-------------|-------------|-------------|-----------|----------------------|-------------|-----------|-------------|-------------|----------|
| Revenue Source | Actual | HJR 2 | | | RTIC Recommendations | | | Difference | | |
| | Fiscal 2005 | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium |
| Property Tax | \$167.270 | \$173.804 | \$180.062 | \$353.866 | \$176.391 | \$182.900 | \$359.291 | \$2.587 | \$2.838 | \$5.425 |

COMMON SCHOOL INTEREST AND INCOME

Revenue Description:

Lands granted by the federal government to the state for the benefit of public schools generate income. The common school trust is actually part of the trust and legacy trust fund that includes nine other trusts. Prior to fiscal 1996, interest and income from the common school trust was deposited in the state equalization account. Beginning in fiscal 1996, this interest and income was deposited in the general fund, as mandated by SB 83, passed by the 1995 legislature. Beginning fiscal 2003, House Bill 7 from the August 2002 special legislative session changed the deposit to the state special revenue guarantee account and statutorily appropriated the money for schools. The estimates show the amount of revenue deposited to the guarantee account and are net of amounts diverted (of mineral royalties, timber sale revenue, and income) for DNRC administration costs. Included is timber revenue for school technology and the amounts of mineral royalty revenue that is required to pay interest and principal on the SB 495 loan. These items are explained below.

Common school lands produce two kinds of revenue: 1) distributable income such as interest earnings, agricultural rents or crop shares, and timber sale revenue; and 2) permanent income that is returned to the trust such as income from the sale of minerals (see the effects of Senate Bill 495 from the 2003 legislative session below), land, and easements. Excluding the amount of timber sale revenue diverted for DNRC administration and school technology and after a 3.0 percent deduction of the revenue for use by the Department of Natural Resources and Conservation (DNRC), 95 percent of distributable revenue is available to fund schools and, due to Senate Bill 48 (discussed below), the remaining 5.0 percent is available to fund the Trust Land Management Division of DNRC. The 3.0 percent allocation to DNRC is used for resource development purposes. Timber revenue is allocated: 1) first to DNRC to fund a portion of its timber program based on the amount appropriated by the legislature (the remaining portion is funded with timber sale revenue from the capital land grant and other land trusts that generate timber revenue); 2) the amount received from production over 18 million board feet is deposited into the state special revenue fund for school technology equipment and training and is statutorily appropriated to OPI (House Bill 41 enacted by the 2001 legislature and House Bill 7 from the August 2002 special legislative session); and 3) any remainder for the support of public schools.

Senate Bill 48, passed by the 1999 legislature, provides for the diversion of the following funds for the purpose of funding the Trust Land Management Division in the DNRC: 1) mineral royalties; 2) revenues from the sale of easements; and 3) 5.0 percent of interest and income previously credited to the common school trust. The amount of the money diverted from the common school trust reduces the growth of the trust fund balance and, hence, reduces the amount of distributable interest earnings.

As of October 1, 1995, all fixed-income investments held by the state's major trust funds (which include the trust and legacy fund of which the common school trust is a part), were transferred to a newly-created Trust Fund Bond Pool (TFBP). The majority of common school trust funds are invested as part of the TFBP. Some funds, however, are invested on a short-term basis in the state's Short Term Investment Pool (STIP). The state Constitution prohibits the investment of common school trust funds in common stock. Interest income is distributed 95 percent to the guarantee account and 5 percent is available for DNRC administration with the remainder deposited to the trust.

Senate Bill 495 (enacted by the 2001 legislature) authorized DNRC to purchase the mineral production rights (with a loan from the coal severance trust) from the common school trust. The department subsequently purchased \$138.9 million of future mineral royalties (over an approximate 30-year period) from the school trust for \$46.4 million. Since these royalties will no longer be deposited to the

trust, interest earnings from the trust corpus are lessened. However, additional interest earnings are generated from the proceeds of the sale, but it is estimated that interest losses will exceed interest gains after fiscal 2012. It is estimated that the trust balance will be \$94.7 million less after the 30-year period. For further information and analysis on Senate Bill 495 contact the Legislative Fiscal Division for a copy of the two-part report: "Senate Bill 495-Implementation, Impacts and Implications".

Applicable Tax Rate(s): N/A

Distribution:

As described above, interest and income from common school lands (including a portion of timber sales and after amounts diverted for DNRC administration) are distributed 95.0 percent to the state special revenue guarantee account and is statutorily appropriated for schools. The remaining 5.0 percent is available to fund the Trust Land Management Division with the remainder deposited to the trust fund. The amounts deposited to the guarantee account are shown in this revenue source.

Collection Frequency:

Revenue is received monthly, however, distribution to the state special revenue fund takes place three times per year.

Statutory Reference:

Tax Rate – NA

Distribution (MCA) – Montana Constitution Article X, Section 5; 20-9-342 (school technology); 20-9-622 (guarantee account)

Other (MCA) –DNRC trust land administration diversion (77-1-109)

DNRC timber sale program diversion (77-1-613)

DNRC land bank administration diversion (77-2-362)

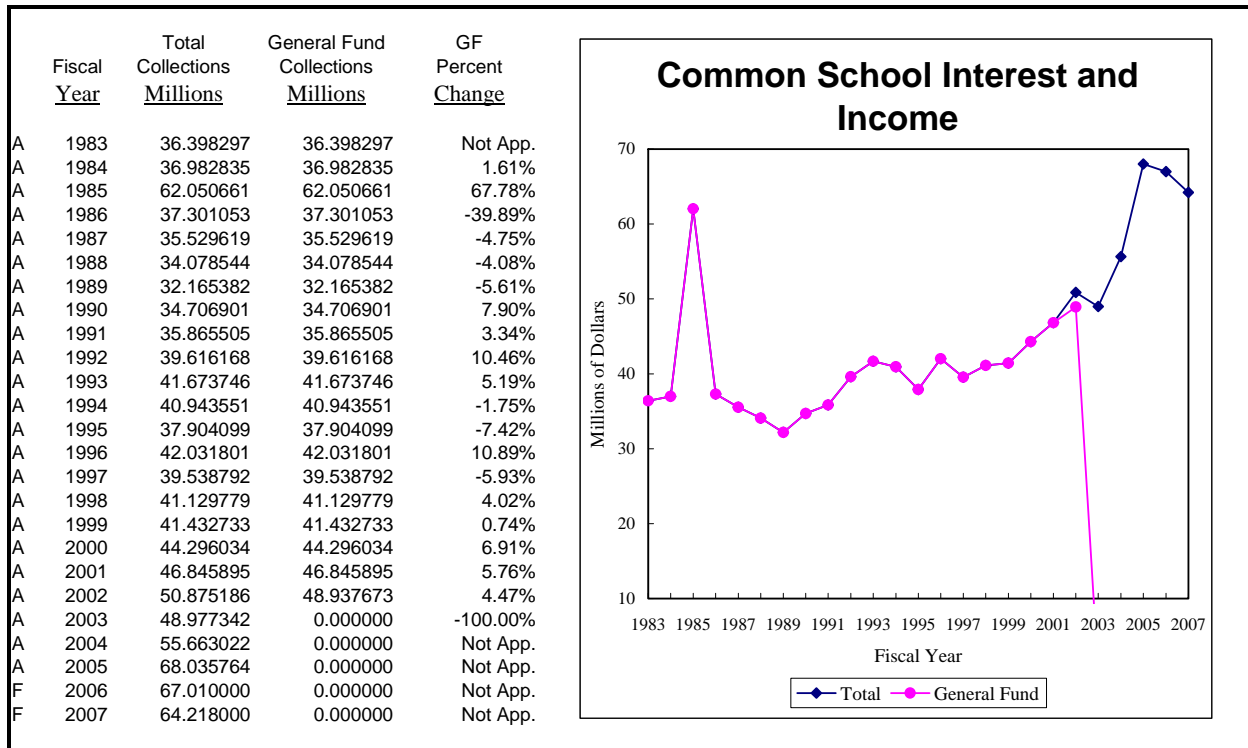
DNRC resource development diversion (77-1-607)

Enabling Act, Section 10

Date Due - the last business day of February following the calendar year in which the money was received (20-9-342).

Additional Information Since Adjournment:

Although the committee directed staff to limit their review and potential adjustments to only income taxes, corporation income taxes, and oil and natural gas production taxes, it did request staff to calculate the associated impact on common school interest and income revenues if adjustments were adopted for oil and natural gas price and production levels.

Revenue Projection:**HJR2 Comparison:**

| Revised HJR 2 Non-general Fund Revenue Estimates (In Millions) | | | | | | | | | | |
|--|-------------|-------------|-------------|-----------|----------------------|-------------|-----------|-------------|-------------|----------|
| Revenue Source | Actual | HJR 2 | | | RTIC Recommendations | | | Difference | | |
| | Fiscal 2005 | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium | Fiscal 2006 | Fiscal 2007 | Biennium |
| Common School I & I | \$68.036 | \$57.146 | \$56.233 | \$113.379 | \$67.013 | \$64.225 | \$131.238 | \$9.867 | \$7.992 | \$17.859 |

